1953

Recommendations for amendment of federal tax laws submitted to the 83rd Congress, first session, January 1953

American Institute of Accountants. Committee on Federal Taxation

Recommendations For Amendment of Federal Tax Laws

☆

Committee on Federal Taxation
American Institute of Accountants

Submitted to the 83rd Congress, First Session, January 1953

☆

American Institute of Accountants
270 Madison Avenue, New York 16, N. Y.

AMERICAN INSTITUTE OF ACCOUNTANTS

Committee on Federal Taxation

FOR THE FISCAL YEAR 1951-1952

THOMAS J. GREEN, *General Chairman*......New York

SUBCOMMITTEE ON CURRENT TAX LEGISLATION

WALLACE M. JENSEN, *Chairman*......Michigan

ROBERT CALDWELL, JR......Pennsylvania
ERNEST H. GRISWOLD......Massachusetts
BENJAMIN HARROW......New York
J. K. LASSER......New York
CHARLES MELVOIN......Illinois
LESLIE MILLS......New York
HILARY H. OSBORN......Tennessee
J. A. PHILLIPS......Texas
CHARLES N. WHITEHEAD......California

SUBCOMMITTEE ON LONG-RANGE TAX POLICY

J. S. SEIDMAN, *Chairman*......New York

RUSSELL S. BOCK......California
ALVIN W. BURKET......Virginia
WALTER M. BURY......Michigan
HAL CANARY......Tennessee
JOHN S. COWING......Pennsylvania
MARY E. MURPHY......California
SAMUEL A. SAKOL......Illinois
L. M. STERNRICH......New Jersey
BRADLEY O. TURNER......Kentucky
CLARENCE L. TURNER......Pennsylvania

SUBCOMMITTEE ON TAX ADMINISTRATION

W. H. DANNE, *Chairman*......Washington, D. C.

MICHAEL D. BACHRACH......Pennsylvania
WILLIAM J. CARTER......Georgia
JAMES MADISON GILLEY......Virginia
WALLER W. GROGAN......Kentucky
WILLIAM W. JOHNSTON......Massachusetts
I. H. KREKSTEIN......Pennsylvania
JOHN F. PRESCOTT......North Carolina
MARK RICHARDSON......Washington, D. C.
TROY G. THURSTON......Indiana
ROSS T. WARNER......Oklahoma

CHARLES E. SIGETY......*Assistant to the Committee*

Recommendations For Amendment of Federal Tax Laws

☆

Committee on Federal Taxation
American Institute of Accountants

Submitted to the 83rd Congress, First Session, January 1953

☆

American Institute of Accountants
270 Madison Avenue, New York 16, N. Y.

Additional copies of this pamphlet
may be obtained by writing to the
American Institute of Accountants
270 Madison Avenue
New York 16, New York

☆

American Institute of Accountants
INCORPORATED UNDER THE LAWS OF THE DISTRICT OF COLUMBIA
THE NATIONAL ORGANIZATION OF CERTIFIED PUBLIC ACCOUNTANTS
270 MADISON AVENUE, NEW YORK 16, N. Y.

January 5, 1953

Committee on Ways and Means
House of Representatives
Washington 25, D. C.

Gentlemen:

The American Institute of Accountants, representing more than 20,000 Certified Public Accountants in the United States, submits herewith, through its Committee on Federal Taxation, recommendations for the amendment of the Internal Revenue Code. These recommendations have been formulated as a result of study and discussion covering a period of about two years. The Committee believes there is urgent need for the serious consideration of the subjects covered in the recommendations. The Committee on Federal Taxation further believes that the adoption of the suggestions herewith submitted will materially strengthen the Code and will result in more equitable taxation through the elimination of a number of inequities.

Sometimes these inequities are the result of judicial or administrative interpretation which deviate from Congressional intent. In other cases, unforeseen situations have arisen that were not contemplated when the legislation was adopted. However, whatever the cause, such inequities should be promptly cured else the taxpayers of our nation will lose confidence in the fairness of the tax structure. That situation already exists in many nations of the world. Evasion and dishonesty have become rampant in some foreign countries because of the loss of faith by the taxpayers. That situation must be avoided here at all costs. Our tax system is fundamentally one of self-assessment and its preservation depends on the continued belief by the taxpayers of fairness to all.

Although the Committee on Federal Taxation firmly believes that the enclosed recommendations should be adopted, it is more deeply conscious of the need for a complete overhauling of our Federal tax laws toward the end of embracing more adequately generally accepted accounting principles. Recognition of generally accepted accounting principles will go a long way toward eliminating many of the inequities in the present Internal Revenue Code and make for greater simplicity.

To accomplish such a needed overhauling, the American Institute of Accountants has for many years advocated the creation of a nonpartisan commission to be composed of representatives of Congress and the executive branch of the Government and of accountants, lawyers, and representatives of other groups such as labor. The American Institute of Accountants continues to urge the establishment of such a commission.

These 58 recommendations do not purport to comprehend everything needing correction in the existing law, but represent, rather, the results of the committee's work to date. The committee is continuously considering meritorious proposals for the revision of the Internal Revenue Code and as additional recommendations are formulated, they will be submitted in subsequent reports.

In substantially identical form, these recommendations have been submitted to the Chief of Staff of the Joint Committee on Internal Revenue Taxation pursuant to a questionnaire formulated by said Chief of Staff.

Respectfully submitted,

THOMAS J. GREEN, *General Chairman*
Committee on Federal Taxation

WALLACE M. JENSEN, *Chairman*
Subcommittee on Tax Administration

Recommendations

for Improvement of Federal Tax Legislation
and its Administration
by Committee on Federal Taxation,
American Institute of Accountants, January, 1953

Summary

1. Conformity with Generally Accepted Accounting Principles

Accounting for income tax purposes should be brought into closer conformity with generally accepted accounting principles by enacting legislation covering at least the four matters set forth below.

a. *Prepaid income.* Deferment of reporting of prepaid income in accordance with generally accepted accounting principles should be authorized in cases where such procedure is called for by the method of accounting consistently employed by the taxpayer.

b. *Accrual of property and other taxes.* Taxpayers should be permitted to deduct tax accruals, in accordance with generally accepted accounting principles consistently employed by them, ratably over the period for which the taxes are imposed.

c. *Apportionment of taxes between vendor and vendee.* Property taxes should be deductible by vendor and vendee of real property in the amounts apportioned to each in accordance with local practice or statute.

d. *Estimated expenses and losses.* Deduction should be allowed for all estimated expenses and losses applicable, under generally accepted accounting principles, to the income of the taxable year, the reasonableness of which can be established by the past experience of the company or of comparable companies or businesses, or by the facts of the situation.

2. *Extend Due Date [53(a)(1)]*

The due date for filing tax returns should be changed to the 15th day of the fourth month following the close of the taxable year.

3. *Liberalize Extension Privilege [53(a)(2)]*

Taxpayers should be permitted to elect an extension of time up to a maximum of two months for filing a return.

4. *Extend Filing Date for Final Estimate [58, 59]*

The due date for filing the final amended declaration of estimated tax and payment of the tax should be changed from January 15th to February 15th, to permit more taxpayers to file a final return in lieu of an amended declaration, thereby enabling the Bureau to process only a return instead of a return and a declaration.

5. *Test for Penalty for Underestimating [294(d)(2)]*

The test for the penalty for substantial underestimation of tax should be based upon the tax liability shown in the return involved rather than upon the liability as finally determined, or, at least, no penalty for underestimating tax should be made upon a showing of reasonable cause for the underestimate.

6. *Head of Household Provisions [12(c)]*

Section 12 (c) should be amended to restore the former head of household rules so that its benefits will not depend on the actual residence together of the head of the household and his relative or dependent.

7. *Taxing Income from Annuities [22(b)(2)]*

The method of taxing annuities should be revised so as to treat as income so much of each year's annuity receipts as represents a ratable portion of the difference between the cost of the annuity contract and the aggregate of the annuity payments that would be received if the annuitant lived out his life expectancy as set forth in a standard mortality table, or, at least, to provide a lower and more realistic rate than three per cent.

8. Retirement Income for the Self-Employed

Legislation should be enacted to provide for the postponement of tax on limited amounts of earned income set aside by self-employed persons and others not covered by existing pension plans in restricted retirement funds, as outlined in H.R. 8390 and 8391, introduced in the 2nd session of the 82nd Congress.

9. Permit LIFO at Lower of Cost-or-Market [22(d)]

The Code should be amended to permit taxpayers using the LIFO inventory method for income tax purposes to value their inventories at the lower of cost or market while the Excess Profits Tax Act of 1950 is in force, and for five years thereafter.

10. Eliminate Double Taxation of Corporate Income

The present double taxation of corporate income — once to the earning corporation, and again to the stockholders upon distribution of such income as dividends — should be mitigated and eventually eliminated. This double taxation has two aspects: (1) tax on intercorporate dividends and (2) tax on dividends paid to non-corporate shareholders without credit either to the corporation or to the shareholder. The tax on intercorporate dividends should be eliminated. Non-corporate shareholders should be allowed a credit against individual income tax of a percentage of dividend income equal to the initial combined rate of normal tax and surtax on individuals, such credit not to exceed the tax, otherwise determined, after applying the credits provided in Sections 31 and 32 but before applying the credit provided in Section 35 of the Internal Revenue Code.

11. Liberalize Depreciation Allowances

The Bureau of Internal Revenue should adopt a more liberal attitude in accepting reasonable allowances for depreciation as determined by taxpayers.

12. Allow Cost of Contesting Tax Liability [23(a)]

The cost of contesting the tax liability should be deductible under Section 23 (a).

13. Tax Some Corporations as Partnerships

The Code should be amended to grant the irrevocable option of being taxed as a partnership to a corporation, 50 per cent of whose stock is owned directly or indirectly during the last half of the taxable year by or for not more than five individuals.

14. Revise Definition of Fiscal Year [48(b)]

The definition of fiscal year should be extended to include annual accounting periods consisting of multiples of weeks instead of months (such as 13 four-week periods, etc.).

15. Fiscal Year Taxpayers

It is recommended that substantive changes in the tax laws should be made applicable on a calendar year basis and that fiscal year computations shall be on a pro rata basis for the two calendar years involved.

16. Remove Two Per Cent Tax on Consolidated Returns

The 2 per cent additional tax applicable to consolidated returns should be eliminated.

17. Amend Section 102

a. At taxpayer's option dividends paid after the end of the taxable year, but before the due date (original or extended) of the tax return, should be allowed as a credit in computing undistributed Section 102 net income.

b. In the event of imposition of surtax under Section 102, the corporation should be permitted to relieve itself of such tax, in whole or in part, by a deficiency dividend under conditions and procedure now prescribed in Section 506 for personal holding companies, or, alternatively, by filing consent dividend papers, as provided in Section 28, effective as of the original taxable year.

c. That the Commissioner has the burden of proof of showing that the profits of a corporation have been accumulated beyond the reasonable needs of the business.

18. Personal Holding Company Gross Income

For the purpose of Subchapter A, dealing with Personal Holding Companies, gross income from the sale of products or services should be defined to mean "gross receipts" from sales.

19. Revise Rules for Personal Holding Companies

a. Effectuation of deficiency dividends by consent dividend procedure should be authorized.

b. Deficiency dividend procedure should not be denied in cases of non-fraudulent delinquency in filing personal holding company tax returns.

c. The deduction of the federal income tax, in computing undistributed Subchapter A net income, should be clearly stated to be the tax for the taxable year, whether the corporation is on the cash basis or the accrual basis.

20. "Gross Receipts" of Subsidiary [23(g)(4)]

For the purpose of Section 23 (g) (4), which excludes from the capital-loss category loss from worthlessness of stock in a virtually wholly owned subsidiary of a domestic corporation, if more than 90 per cent of the subsidiary's gross receipts for its entire history was from other than investment sources, gross income from the sale of merchandise, stock in trade, or property held primarily for sale to customers in the ordinary course of the trade or business, should be deemed to mean "gross receipts" from such sales.

21. Enlarge Definition of Business Bad Debts [23(k)]

Section 23 (k) of the Internal Revenue Code should be amended to exclude from the definition of non-business bad debt those debts which arise in the course of a taxpayer's trade or business, or which represent loans or advances to business organizations in which the taxpayer has a financial interest either as an employee, stockholder, or creditor.

22. Contributions to Non-Exempt Employees' Trusts

The Internal Revenue Code should be amended to provide that taxpayers making contributions to a profit-sharing or pension trust not exempt under Section 165 should be allowed a deduction from net income for such payments in the year the amounts are paid to the employee by the trust even though the rights of the employee were forfeitable when the contributions were made.

23. Payments to Employees' Pension and Profit-Sharing Plans [23(p)(1)(E)]

A taxpayer on the accrual basis shall be deemed to have made a payment under Section 23 (p) on the last day of accrual if the payment is on account of that taxable year and is made up to the time of the due date for the filing of the return for that taxable year, including any extension of time for filing the return.

24. Basis After Sale at Loss to Related Taxpayer [24(b)]

When loss on the sale of property is disallowed by reason of the relation of the parties, the subsequent basis of the property for purpose of determining gain should be the transferror's basis.

25. Unpaid Expenses Under Section 24(c)

The limitations of Section 24 (c) should not apply to deny deduction to an accrual basis taxpayer of unpaid expenses and interest if the person to whom the payment is made elects at any time within the statutory period of limitations with respect to the taxable year of the payor to include such payment as income in a taxable year beginning not later than the end of the taxable year of the payor during which the payment accrued.

26. Accrued Deductions Upon Liquidation [42(a)]

If, upon liquidation, a cash basis corporation is required to recognize accrued income, it should also be permitted to recognize accrued deductions.

27. Liberalize Qualification of Instalment Sale [44(b)]

The Code should be amended to provide that the absence of any payments in the year of a sale of realty or a casual sale of personalty will not prevent the transaction from being an instalment sale.

28. Change to Instalment Basis [44(c)]

Taxpayers changing from the accrual to the instalment basis of reporting income should be granted a limited credit for the tax already paid on the portion of their income which was reported under the accrual basis in earlier years.

29. Successor Corporation Tax-Free Reorganization [112, 113]

Where a corporation is formed or availed of to acquire the assets and become the successor, in a tax-free reorganization, of a predecessor corporation, which, in pursuance of the plan, is liquidated and dissolved, the successor corporation should step into the "tax shoes" of the predecessor corporation.

30. Sale of Corporate Assets Followed by Liquidation [112]

The Code should be amended to provide that in the case of the sale of all the assets of a corporation followed by the liquidation of the selling corporation within a reasonable period of time, no gain or loss should be recognized by the selling corporation if the transaction is part of a plan to sell its assets and liquidate completely.

31. Nonrecognition of Gain in Corporate Liquidations [112(b)(7)]

Section 112 (b) (7) should be amended to include liquidations made after 1952. The election privilege should be allowed up to the time of the filing of the return for the taxable year involved.

and should be made effective for years beginning after December 31, 1950.

32. Transfer of Assets in a Reorganization [112(g)(1)(C)]

A transfer of substantially all the assets of a corporation to another corporation should not be disqualified as a "reorganization" under Section 112 (g) (1) (C) merely because the voting stock received in exchange is that of a parent company of the transferee corporation.

33. Net Operating Loss Deduction [122(d)(5)]

Section 122 (d) (5) provides (for taxpayers other than corporations) for allowance of losses in the computation of net operating loss deduction only if they are attributable to the operation of a trade or business regularly carried on by the taxpayer. The Section should be amended to provide for recognition in the computation of net operating loss deduction of losses on disposal of assets used in a trade or business by a non-corporate taxpayer.

34. Statute of Limitations When Gross Income Is Omitted [275(c)]

The five year statute of limitations should not be applied, even if more than 25 per cent of gross income is omitted from a return, provided that there was adequate disclosure of the omitted item in the return.

35. Limitation on Amount of Credit or Refund [322(b)(3), (4)]

Where a claim for credit or refund is filed within three years of the filing of the return, it should apply to all amounts paid prior thereto with respect to that year even though the claim is filed more than three years from the time of payment of the tentative tax.

36. Interest on Deficiences and Overassessments [3771]

The provisions of the code with respect to interest on deficiencies and overassessments should be amended to provide for consistent and more equitable treatment between deficiencies and overassessments.

37. Easing Effects of Statute of Limitations [3801]

Recommendations re mitigation of the effect of statute of limitations. The law should be amended to cover the following:

1. When a deduction is made in good faith on the tax return of one year and is disallowed by the Commissioner on the ground that it was deductible in a return of a different year.

2. When income is included by the taxpayer in good faith in one year and is held by the Commissioner to be taxable in another year.

3. When the basis of an asset claimed by taxpayer is reduced by the Commissioner for the purpose of computing net income of one year on the ground that the reduction of the basis should have been made in another year.

4. When income or deductions are included or deducted by one member of an affiliated group, as defined in Section 141 (d), and are allocated by the Commissioner to another member of the group.

5. When income or deductions are included in good faith in the tax return of one taxpayer but are adjusted by the Commissioner because of another taxpayer's error.

6. When income or deductions are included in good faith on the tax return of one taxpayer and adjustments are made by the Commissioner in respect to a related taxpayer under the provisions of Section 45.

38. Basis of Property Acquired by Gift

The basis of property, acquired by gift but subjected to estate tax in the estate of the donor, should be the same as in the case of property passing by death and not previously made the subject of a gift.

39. *Mortgaged Property Bid In By Creditor*

Where the holder of a mortgage or other debt forecloses on the security or collateral, and himself bids in the mortgaged or pledged property, the fair market value of the property thus bid in should be treated as a payment on account of the debt, and the deductibility and time of deductibility of the balance of the debt should be determined under the usual rules applicable to deduction of debts worthless in whole or in part.

40. *Effect of Payments Under Section 16(b) of Securities Exchange Act*

Payments required to be made to a corporation by persons subject to Section 16 (b) of the Securities Exchange Act of 1934 should be treated for tax purposes as a short-term capital loss, or as an adjustment of the cost of the stock.

41. *EPT — Need for General Relief Provision*

There is definite need for a general relief provision to supplement the existing rigid qualifying tests that determine a corporation's eligibility for relief.

42. *Irrevocable Elections*

a. The irrevocable election required by Section 437 (b) (1) in order to compute invested capital under the historical invested capital method provided in Section 458 is unfair, and should be changed to allow the taxpayer to make a revocable election.

b. Under Section 433 (a) (l) (j), the election to compute the net operating loss deduction by taking the "base period" loss adjustment as the net operating loss carry-over from the last taxable year which ended before 7/1/50 should not be irrevocable.

43. *Determination of Unused Excess Profits Credit [432(b)]*

The unused excess profits credit should be determined without the allowance of the net operating loss deduction as provided for in Section 23 (s), but only as to net operating losses arising in years prior to excess profits tax.

44. Unused EP Credit Applicable to Short Taxable Year [432(c)]

Section 432 (c) should be amended to provide that the reduction of the carry-over when an excess profits credit has been carried back or over a short taxable year, should be scaled down.

45. Interest-Paid Adjustment [433(a)(1)(0)]

The interest paid adjustment should not be used to correct for interest income from loans to a member of a controlled group: instead, it would be preferable to provide for an additional interest received adjustment to be correlated directly with an increase in loans to a member of a controlled group.

46. Interest Adjustment [433(a)(1)(0) and 445(b)(1)]

The interest adjustment under Section 433 (a) (1) (I) should not be made when average base period net income is computed under Section 445 (b) (1).

47. Abnormal Deductions [433(b)(9) and (10)]

The statutory provisions relating to abnormal deductions should be amended, as follows:

1. The 5 per cent limitation should apply to the aggregate abnormal deductions and not separately to each class.
2. In any event the "cause" test should be eliminated since a percentage limitation and the "consequence" requirement should be a sufficient limitation for the test of whether deductions are abnormal in character as well as in amount.
3. The statute should be clarified to include as abnormal deductions elements of the cost of goods sold as well as statutory deductions.

48. Qualification for Growth Formula [435(e)]

a. Other than for the exception relating to Section 23 (p), the total payroll to be used in determining the test of a growth corporation should include non-cash compensation.

b. The limitation of the growth formula to corporations with assets of less than $20,000,000, as required by Section 435 (e) (1) (A) (i), should be eliminated.

49. Determining Base Period Capital Addition [435(f)(2)]

For the purpose of determining the base period capital addition, a corporation should be given the benefit of two full 12 month periods, even though it might be necessary to prorate the increase or decrease in an earlier period in order to accomplish that result.

50. Computing Borrowed Capital [435(f) and (g)]

Under 435 (f), borrowed capital, inadmissible assets and loans to members of a controlled group should be computed on an average daily basis and such average be compared with the beginning date during the base period for purposes of measuring the base period capital addition under the income credit method.

51. Loans to Members of Controlled Groups [435(g)]

a. Loans to members of controlled groups should be treated under the invested capital credit method as now treated under the income credit method, with an appropriate adjustment for interest received.

b. Just as increases in investments in and loan to members of a controlled group give rise to capital reductions, so decreases in investments in, and loans to, members of such groups should give rise to capital additions.

52. Recent Loss Adjustment [437(f)(3)(B)]

Section 437 (f) (3) (B) should provide (1) that the recent loss adjustment of a component which has not transferred all of its properties should be allocated between the component and the acquiring corporation and (2) for proration of the recent loss adjustment if the transaction occurs during an excess profits tax year.

53. Distributions to Shareholders [441(e)]

a. The rule outlined in this section that distributions made to shareholders during the first 60 days of a taxable year which do not exceed the accumulated earnings and profits as of the beginning of the taxable year are considered to have been made on the last day of the preceding taxable year should not be applied to base period years.

b. Section 441 (e) should not apply to any distributions to shareholders in the taxable years subject to EPT made prior to January 3, 1951 (the date of enactment).

c. A dividend should not be treated as a liability until the date that it is payable, or until it is paid, if no date of payment is specified, for the purposes of this section.

54. Reconstruct Base Period Years [442(b) and (c)]

A corporation should be permitted to reconstruct up to two of the four base period years if one of such years was to be eliminated and, in any event, the corporation should be permitted to reconstruct one year before making the elimination of one out of the four years.

55. Relief on Combined Basis After Part II Transaction [444, 446]

The Code should be amended to provide that a corporation be permitted to use the relief sections notwithstanding its acquisition of components which themselves would not be entitled to relief, providing that the corporation meets the qualifications for relief on a combined basis.

56. Calculating Industry Rates of Return [447]

a. The industry rate of return provision should be amended to provide that the rate of return, calculated by the Secretary of the Treasury, should be the average for the industry's best three years out of the four year period, 1946 through 1949.

b. The industry rates of return should be more accurately determined because as presently computed they ignore the adjustments required to be made after examination of returns by Revenue Agents to reflect the excess profits credit. Some percentage adjustment is needed to allow for these over-all factors, and it is urged that the Secretary of the Treasury be directed to make a study to determine the amount of the adjustment.

c. The Secretary of the Treasury should be directed to make a study leading to the calculation of rates of return for each of the 3 digit subgroups listed under the major industry groups in the Standard Industrial Classification Manual.

57. Definition of "Property Paid In" [458(d)(2)]

The definition of "property paid in" for the computation of historical invested capital should include the value of services rendered and the amount of debts liquidated through the issuance of shares of stock or paid in as a contribution to capital.

58. Allocation of EP Credit of Component Corporation [461]

a. Under Section 461 (c), adjustments of the excess profits credit by the component corporation should be required only if the acquiring corporation takes advantage of the exchange provisions.

b. The organization of a new subsidiary by the transfer of cash alone to the subsidiary by a corporation in exchange for stock should not be treated as a Part II transaction or, in the alternative, should be treated as a Part II transaction only at the election of the taxpayer.

Income Tax

RECOMMENDATIONS

Conformity with Generally Accepted Accounting Principles

1 *Accounting for income tax purposes should be brought into closer conformity with generally accepted accounting principles by enacting legislation covering at least the four matters set forth below.*

EVER INCREASING DIVERGENCES between rules of accounting for tax purposes (as prescribed by regulations, rulings, and court decisions), on the one hand, and generally accepted accounting principles (as universally applied in determining net income for commercial management and investment purposes), on the other hand, has been and continues to be the despair of businessmen, accountants, and tax practitioners alike. Such divergences not infrequently result in taxing as income what is actually capital. They are a continuous source of irritating adjustments of tax returns which, in the long run, yield no revenue to the government, because they merely represent shifts of income between years. The advantages, in terms of simplicity, of maximum conformance of tax accounting with the accounting methods employed in the taxpayer's accounting records, and in the preparation of his financial and credit reports, are self-evident.

There is no question but that it was the basic intention that generally accepted accounting principles be applicable for tax purposes. Thus Section 41 of the Code provides that

"The net income . . . shall be computed in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

The regulations (Reg. 111) provide:

"Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer." (Sec. 29.21-1)

"If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for." (Sec. 29.41-1)

"Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." (Sec. 29.41-2)

"It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose." (Sec. 29.41-3)

The Supreme Court, in the leading case of *U. S.* v. *Anderson*, 269 U. S. 422 (1926) in referring to the original statutory forerunner of the above quoted excerpts from Section 41, and to an early Treasury Decision to the same effect, stated:

"It (the Treasury Decision) recognized the right of the corporation to deduct all accruals and reserves without distinction made on its books to meet liabilities, provided the return included income accrued and, as made, reflected true net income. . . . It (the purpose of the statute) was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during a taxable period, the expenses incurred in and properly attributable to the process of earning income during that period."

In this statement, the Supreme Court not only succinctly and accurately stated the primary objective of all generally accepted accounting principles — to have each accounting period reflect the income *earned* in that period and the expenses incurred in and properly attributable to the process of earning that income — but, what is even more important, recognized that it was the purpose of the taxing statute to give effect to these principles, and, to that end, to permit taxpayers "to deduct all accruals and *reserves* without distinction made on its books to meet liabilities."

However, in the twenty-six years following the *Anderson* decision, judicial interpretations of that decision and of the later decision in *North American Oil Consolidated* v. *Burnet,* 286 U. S. 417 (1932) have resulted in distortions of and departures from the scientific accounting principles, recognition of which the *Anderson* decision had declared to be the purpose of the taxing statute.

These distortions and divergences have occurred chiefly in the four directions set forth below:

a. Prepaid income:

Deferment of reporting of prepaid income in accordance with generally accepted accounting principles should be authorized in cases where such procedure is called for by the method of accounting consistently employed by the taxpayer.

Payments received in advance for the use of property in future years or for services to be rendered in future years should be included as income in the future years to which applicable and not in the year of receipt. This is well-recognized and established accounting procedure. It is only in this way that income such as rentals, and club dues, etc., can be clearly reflected by including the income in the period in which it is earned and in which are incurred the costs and expenses of earning it. In fact, until such expenses and costs are incurred in the future period, it cannot be known whether the advance receipts of rentals, etc., will represent a net income or a net loss.

However, the Courts have held htat income received in advance is nevertheless taxable in year of receipt, even where there is a continuing obligation to perform services and incur expenditures over a period of time in order to earn the income, and despite the fact that generally accepted accounting principles, and the accounting methods consistently employed by the taxpayer, call for the deferment of the reporting of such income until the period or periods in which such income is earned by the rendering of the services and the incurring of related expenditures. This has created all sorts of absurd tax results, arising out of the basic difficulty that net income is bound to be distorted if the income is required to be included in one period, while the related expenditures are included in a later period.

This distortion is accentuated by the fact that, in contrast to their treatment of income, the Courts require that expenses paid in advance or which benefit future periods be not permitted as deductions in the year of payment or accrual, but only in the future years to which the expenses are applicable.

A striking example of such distortion occurs where a landlord, employing the accrual method of accounting, in order to finance the payment of the broker's commission on a long-term lease, arranges for the payment in advance of rentals applicable to the last few years of the lease. The decisions have held that the rental thus received in advance must be included in taxable income in the year of receipt, whereas the broker's commissions, which such advance rentals were intended to finance, may not be deducted in the year of payment, but must be spread over the life of the lease. In such cases the result frequently is an abnormally large and unreal taxable net income in the first year of the lease, and equally unreal losses in the last few years of the lease — not by reason of any actual variations in results of operations, but solely by reason of the artificial accounting procedure enforced for tax purposes.

b. Accrual of property and other taxes:

Taxpayers should be permitted to deduct tax accruals, in accordance with generally accepted accounting principles consistently employed by them, ratably over the period for which the taxes are imposed.

It is universally accepted accounting practice to regard taxes as an expense of the period for which levied. Thus if a property tax is imposed for the calendar year 1952, it is regarded as an expense of that calendar year, regardless of local peculiarities of assessment or lien dates, and if, for example, the taxpayer should be on a fiscal year ending May 31st, 5/12 of such tax would be included as an expense for the year ended May 31, 1952, and 7/12 would be included as an expense for the year ended May 31, 1953. Again, if a corporation franchise tax based upon the income of a given period should be imposed for the privilege of carrying on business for a future period, the accepted accounting practice would be to treat such tax as an expense of the privilege period for which the tax is imposed.

Under the court decisions, however, it is held that accrual of a tax occurs upon the date when the amount and liability for the tax become fixed and that the entire tax is deductible on, and only on, that single date. Thus, in many jurisdictions, the amount and liability for a property tax for the calendar year 1952 would be fixed some time late in 1951, and, under such court decisions, would be deductible, on the accrual basis, only at that time, whereas in other jurisdictions, the amount and liability for the tax for 1952 would not be determined until some time in 1952 and would be deductible only on that date. Where the income tax year of the taxpayer varies from the property tax year of the local jurisdiction, many other peculiar variations ensue.

The result has been an utterly confusing pattern, in which deductibility of taxes varies from community to community, depending upon the local peculiarities of assessment date, date of issuance of assessment rolls and tax warrants, lien dates, date upon which personal liability for the tax is determined, etc. In many cases, several property taxes on the same property may be deductible at different dates because of varying assessment and lien dates relating to the village, county, school, and other property taxes imposed in the community.

All of this serves no real practical purpose, since all that is involved is a shift of deductions between years. Consistency in practice and relation of expenses to the period for which imposed are the important factors in clearly reflecting income. The artificial rules created by the aforesaid court decisions are not even in accord with local practice (and sometimes local statute)with respect to the apportionment of taxes between vendor and vendee, which is universally based on a prorating of taxes over the period for which imposed.

These comments are not intended to cover taxes, the liability for which is contingent, denied and contested by the taxpayer.

c. Apportionment of taxes between vendor and vendee:

Property taxes should be deductible by vendor and vendee of real property in the amounts apportioned to each in accordance with local practice or statute.

Local practice in all communities is to apportion property taxes between vendor and vendee, upon a sale of real property, by prorating the tax over the tax year for which the tax is imposed. In some cases, such procedure is provided by local statute. Such apportionment is made without reference to assessment dates, lien dates, existence of personal liability for the tax, etc., but is made wholly by reference to the tax year for which the tax is levied.

In many jurisdictions, however, a property tax for the calendar year 1952 would, by reason of the local statutes, have been assessed and become a personal liability of the property owner and a lien upon the property on or before January 1, 1952. In such circumstances, the Supreme Court held, in *Magruder* v. *Supplee,* 316 U. S. 394 (1942), that the vendee who purchases property, for example, after January 1, 1952 — even on January 3, 1952 — and, therefore, pays practically the entire 1952 tax, cannot deduct such tax, because it was not imposed upon him, but was a personal liability of the vendor and a lien upon his property prior to the sale. The vendee, says the Court, is not permitted the deduction because the tax payment by him merely discharges an existing lien upon the property and is therefore a part of his cost. At the same time, however, the vendor may not deduct the tax because he did not pay it.

This is not only an artificial and distorted result, but does complete violence to real estate practice which has been in existence long before the income tax came on to the statute books.

d. Estimated expenses and losses:

Deduction should be allowed for all estimated expenses and losses applicable, under generally accepted accounting principles, to the income of the taxable year, the reasonableness of which can be established by the past experience of the company or of comparable companies or businesses, or by the facts of the situation.

In applying the basic principle of accounting for income, namely, that of including expenses and losses in the period in which is earned the income to which they relate, it is generally accepted practice to provide by estimates for expenses and losses relating to the accounting period and which are reasonably determinable in amount. Such estimates, at least to the extent that experience and surrounding circumstances establish their reasonableness, should be allowed as deductions.

Thus, where accounts receivable are outstanding at the end of a period, it is accepted accounting practice to deduct the estimated loss for the cash discounts which, experience has shown, will be taken by the customers on payment. It has been held, however, that such a loss may not be deducted, because, until the customers actually pay the accounts, it is not known which customers will, and which will not, pay in time to be entitled to the discount — this, despite the fact that experience over a period of years may establish that, with comparatively little variance, a determinable percentage of the customers takes advantage of the discounts. Again, if merchandise is sold under a guarantee, or with an agreement to service or repair the product for a given period, past experience frequently indicates the amount of future repair and service expense, or losses on guarantees on such sales, with a high degree of accuracy, and proper accounting procedure would require that estimates for such future expenses and losses arising out of such sales should be deducted in determining the income realized therefrom. Nevertheless, for the same reasons as in the case of the cash discounts, such items are not allowed, and deduction therefor is not permitted until the period or periods in which the losses are sustained or the repair and service expenses incurred. Under these conditions, the taxpayer is always being subjected to tax on an amount of income, which, in fact, is not income, but capital.

Deduction of such losses is at present permitted by statute in the case of bad debts. The basis of such statutory authorization was generally accepted accounting practice.

This recommendation is not intended to be applicable to "Reserves" as employed by special classes of taxpayers like insurance companies, nor is it intended to cover provisions for unrealized decrease in value of property, for contingencies, or for items the liability for which is contested by the taxpayer.

Extend Due Date [53(a)(1)]

2 *The due date for filing tax returns should be changed to the 15the day of the fourth month following the close of the taxable year.*

SECTION 53 (a) (1) of the Code, at present, requires all tax returns, except the returns of fiduciaries of estate or trusts, to be filed on the 15th day of the third month following the end of the taxable year. It is well known that the taxpayers and their tax advisers have great difficulty in preparing complete tax returns within that short period of time. The vast majority of all tax returns filed — for calendar year taxpayers — must be prepared between January 1st and March 15th. Many taxpayers who are in business have audits after the close of the year which must be completed before the tax return can be prepared. In addition, the government itself is unable to cope with the flood of returns it receives during March, and the opening of mail and the deposit of taxpayers' checks by the offices of the Directors of Internal Revenue are frequently delayed for some time.

Some relief may be obtained by changing the due date for filing returns. The original due date of the 15th day of the third month following the end of the taxable year was set many years ago when there was a relatively small number of taxpayers and the computation of the tax was a simpler matter. Those conditions have changed drastically. Now, nearly every employed person is required to file a return and the taxes themselves have become extremely complicated. More time is urgently needed in which to prepare returns, and it is recommended that one month more be allowed in which to file returns. Taxpayers, their tax advisers and the government would be greatly aided by the additional time, and there would be no reduction of revenues.

Section 53(a) (1) should be amended so that the due date for filing returns is changed to the 15th day of the fourth month following the close of the taxable year.

Liberalize Extension Privilege [53(a)(2)]

3 *Taxpayers should be permitted to elect an extension of time up to a maximum of two months for filing a return.*

SECTION 53(a) (2) of the Code authorizes the Commissioner to grant a reasonable extension of time for filing returns. Authority for granting extensions has been delegated by the Commissioner to the various Directors of Internal Revenue. The usual procedure has been for the taxpayer or his authorized representative to file an application in writing, reciting the reasons which would justify the extension requested. The Director thereupon issues a letter granting the extension but until such letter is received, the taxpayer does not know whether the extension will be granted and cannot file a tentative return since a copy of the letter must be included in such return.

Since almost all applications are granted, considerable time and effort are wasted, both on the part of taxpayers and in the Directors' offices, due to the multiplicity of letters at a time when the Directors' offices are under their greatest period of pressure. This procedure has been alleviated somewhat the last several years since the Commissioner has permitted the application for a corporate extension to be made by a person enrolled to practice before the Treasury Department. While that practice has been helpful, it still results in needless effort at the worst time of the year from the standpoint of the Bureau and of tax practitioners.

Taxpayers should be permitted to obtain an extension of time for filing a return as follows:

a. Corporations should be permitted the right to file a tentative return in which it could elect an extension up to a maximum of two months. The extension could be conditioned upon the payment of the installment of an estimated tax at such time.

b. Individuals and other taxpayers should be permitted to elect an extension up to a maximum of two months by filing a simple form having the effect of a tentative return in which the reasons for such extension are stated. The extension could be conditioned upon the payment of the proportionate amount of estimated tax liability applicable to any class of taxpayers, such as estates or trusts, that the Commissioner, by regulations, might determine to be necessary.

If taxpayers could elect to take advantage of the periods of extension outlined above, unnecessary administrative detail work by the government, taxpayers and tax practitioners could be avoided. If the Bureau considers it necessary, the Director could be required to review the reasons given and where such extensions appear to have been elected for frivolous or inadequate reasons, the Director should be authorized to notify the taxpayer that the period of extension will be terminated on a specified date. A minimum notice of ten days should be required. It is believed that in this manner the Bureau could prevent any abuse of the privilege of an elective extension of time for filing returns. Any further extension of time up to the maximum of six months permitted by law should be applied for as presently required.

If this suggestion cannot be accomplished by a revision of existing Regulations it is recommended that appropriate legislation amending the Code to permit the change in extension procedure be enacted promptly.

This recommendation providing for an extension of time for filing a return up to a maximum of two months is made on the assumption that legislation will be enacted providing for a change in the due date for filing returns from the present two and one half months after the end of the taxable year to three and one half months.

If such legislation is not adopted, and the present two and one half month period is not lengthened, it is recommended that taxpayers be permitted an election of time for filing a return up to a maximum of three months, under the procedures above described.

Extend Filing Date for Final Estimate [58, 59]

4 *The due date for filing the final amended declaration of estimated tax and payment of the tax should be changed from January 15th to February 15th, to permit more taxpayers to file a final return in lieu of an amended declaration, thereby enabling the Bureau to process only a return instead of a return and a declaration.*

UNDER SECTIONS 58 and 59 of the Internal Revenue Code if on or before January 15 of the succeeding taxable year the taxpayer files a return for the taxable year for which the declaration of estimated tax is required, and pays in full the amount computed on the return as payable, such return is considered to be the declaration or amendment thereof. The 15 days allowed after the close of the taxable year is usually not adequate to collect the information required to file a return, (including the W-2 form which is frequently not available until January 31st) with the result that the taxpayer files a January 15th declaration and later files the return. It is recommended that instead of January 15th, the due date be changed to February 15th. The extra time will enable many taxpayers to file a return in lieu of the declaration resulting in economies to the Bureau because it will not have to process both a return and a declaration.

Test for Penalty for Underestimating [294(d)(2)]

5 *The test for the penalty for substantial underestimation of tax should be based upon the tax liability shown in the return involved rather than upon the liability as* *finally determined, or, at least, no penalty for underestimating tax should be made upon a showing of reasonable cause for the underestimate.*

ACCORDING TO THE PROVISIONS of Section 294(d) (2) of the Internal Revenue Code, if the declaration of estimated tax results in a payment of less than 80% of the actual tax there is a penalty of 6% of the difference between the actual and estimated tax (with some exceptions).

The Commissioner has taken the position that the test for the penalty should be based upon the tax liability as finally determined and has been upheld by the Tax Court. This is unfair, for the taxpayer, making an estimate in good faith, should not be penalized for substantial underestimation of tax merely because the tax as shown on his return is changed by a Bureau adjustment which he could not predict when the estimate was filed. Furthermore, a penalty for underestimate may result when reported income or a claimed deduction is merely transferred to another taxable year. Finally, the penalty is clearly absurd when it is required to be measured by the tax liability finally determined by the Courts in meritorious litigation which may be necessary to determine the correct amount of the tax.

Accordingly, it is recommended that the test whether a penalty is incurred for underestimating the tax should be based upon the tax liability shown in the return for the preceding year and not upon the tax liability as finally determined for such year; and the alternative 80% test should be based upon the tax liability shown upon the return for such year and not as finally determined. (It is recognized that fraudulent returns should be excepted from this rule, and that returns must be filed in good faith.)

In the alternative, it is recommended that no penalty for underestimating the tax should be asserted when a showing of reasonable cause can be made, i.e., reasonable cause for not meeting the 80% test (such as an estate distribution during the 65-day period) or the preceding year test because of a Bureau change of the tax liability for the preceding year.

Retirement Income for the Self-Employed

8 *Legislation should be enacted to provide for the postponement of tax on limited amounts of earned income set aside by self-employed persons and others not covered by existing pension plans in restricted retirement funds, as outlined in H.R. 8390 and 8391, introduced in the second session of the 82nd Congress.*

ALTHOUGH the problem of providing for financial security in old age has been made easier for many corporate employees by Section 165 of the Code, no such relief is now available to self-employed persons and others not covered by existing pension plans. This inequity is illustrated by the plight today of professional persons not employed by corporations, and therefore not entitled to the benefits of Section 165. Doctors, lawyers and certified public accountants must devote long years to study and preparation before reaching a comparatively brief period of maximum earning capacity, during which their income is subject to high rates of tax on earned income, making it impossible to provide adequately for retirement. This inequity must be remedied. Self-employed persons and others not covered by existing pension plans should be granted an incentive to save for retirement comparable to that which is now enjoyed by corporate employees who are covered by retirement plans under Section 165. Congressmen Keogh and Reed introduced identical bills (H.R. 8390 and 8391) in the 2nd session of the 82nd Congress, that would amend the Code so that those persons may defer the payment of tax on limited income set aside in restricted retirement funds. The principle of these bills is heartily endorsed and should be enacted into law.

Permit LIFO at Lower of Cost-or-Market [22(d)]

9 *The Code should be amended to permit taxpayers using the LIFO inventory method for income tax purposes to value their inventories at the lower of cost or market while the Excess Profits Tax Act of 1950 is in force, and for five years thereafter.*

ALTHOUGH the last-in, first-out (LIFO) method of inventory valuation was authorized for tax purposes by Congress in 1939, many taxpayers have not adopted it because they feared the consequences of a high-cost inventory base. Prices have been moving steadily upward since 1939. Under the LIFO method taxpayers are not permitted to write down inventories to market price if prices fall below the level in effect when the LIFO method was first elected. Consequently, many taxpayers who now desire to adopt LIFO are unwilling to do so, for they would be required to value their inventories at today's high price levels even though prices fell suddenly and sharply in a subsequent year. In the meantime, inflation is continuing in business inventories and creating unrealized profits, upon which dividends, wage increases and income and excess profits taxes are being paid, contributing to the inflation spiral.

One of the express purposes of Congress in adding Section 22(d)(1) to the Code was to provide a means by which price inflation could be eliminated from business profits and inventory values. This purpose is now frustrated because taxpayers will not adopt LIFO unless they are spared the risks of having a high priced inventory frozen on the books for tax purposes when market prices may have dropped sharply.

Taxpayers using LIFO for tax purposes should be permitted to value their inventories downward for some period lasting until economic conditions have achieved a measure of stability. Accordingly, it is recommended that taxpayers using LIFO be permitted to value inventories at the lower of cost or market while the present Excess Profits Tax Act of 1950 is in force, and for five years thereafter. The excess profits tax law is an emergency measure designed to capture excess profits during the present mobilization period. Unless it is renewed, it will expire on June 30, 1953. By then, it is hoped, world conditions will be calmer, and perhaps five years from then our economy will be functioning on a normal level, and prices will be free from wide fluctuation. During this period, taxpayers may adopt LIFO freely with the knowledge that a sudden price drop will not leave them frozen with inventories value above market level. After that period, further reductions to market should be recognized, but if prices increased, they should be restored to income.

Eliminate Double Taxation of Corporate Income

10 *The present double taxation of corporate income — once to the earning corporation, and again to the stockholders upon distribution of such income as dividends — should be mitigated and eventually eliminated. This double taxation has two aspects: (1) tax on intercorporate dividends and (2) tax on dividends paid to non-corporate shareholders without credit either to the corporation or to the shareholder. The tax on intercorporate dividends should be eliminated. Non-corporate shareholders should be allowed a credit against individual income tax of a percentage of dividend income equal to the initial combined rate of normal tax and surtax on individuals, such credit not to exceed the tax, otherwise determined, after applying the credits provided in Sections 31 and 32 but before applying the credit provided in Section 35 of the Internal Revenue Code.*

AT PRESENT, corporate income is subject to a double burden of tax as compared with business income derived from unincorporated enterprises such as single proprietorships and partnerships. This double taxation becomes multiple taxation where intercorporate stockholdings and parent-subsidiary corporations are involved, since the corporate income, while passing from the original earning corporation to the ultimate non-corporate stockholders, is subject to tax in the hands of each intermediate corporation in the chain of stock ownership. This condition has not only resulted in inequitable taxation of corporate income, but it has exerted a disproportionately powerful influence on the selection between corporate and other forms of doing business, has led to unbalanced and unsound corporate financial structures through the substitution of borrowings, the interest payments on which are deductible, for capital stock issues, the dividend payments on which are not deductible, and has discouraged or imposed a tax penalty on economically necessary and sound parent-subsidiary structures.

This committee is in accord with the almost universal agreement among students in the field of tax revision on the desirability of eliminating or mitigating the multiple taxation of corporate income. It is recognized that the revenue requirements of the Government may make impractical, at this time, complete elimination of the multiple taxation of dividends. Accordingly, this Committee recommends that the inequitable taxation of dividends be mitigated by the allowance of a credit for dividends received by non-corporate shareholders equal to the initial combined rate of normal tax and surtax on individual incomes and by the elimination of the tax on intercorporate dividends.

This suggested plan should be simple to administer; it would involve no refunds; all corporate income would be subject to at least the corporation income tax. Moreover, it would be a move in the right direction toward the eventual complete elimination of the double taxation of distributed corporate income.

Liberalize Depreciation Allowances

11 *The Bureau of Internal Revenue should adopt a more liberal attitude in accepting reasonable allowances for depreciation as determined by taxpayers.*

REPEATED adjustments in depreciation rates have been a major source of irritation in contacts between taxpayers and the Bureau of Internal Revenue, leading either to troublesome litigation or to unsatisfactory compromise to avoid the expense of litigation. Precision is sought where even the best result is but an estimate. In the long run, these adjustments yield no tax revenue, because all that they accomplish is to shift deductions between years. In order clearly to reflect income, so far as depreciation is concerned, consistency in rates from year to year is more important than the precise rates employed as long as the rates are not out of all reason. Room should be allowed for flexibility of judgment on the part of the management in selecting depreciation rates, for tax as well as for general accounting purposes. Accordingly, it is recommended that the Bureau of Internal Revenue adopt a more liberal attitude in accepting reasonable allowances for depreciation as determined by taxpayers. Legislation to accomplish this result should be enacted, if necessary.

Allow Cost of Contesting Tax Liability [23(a)]

12 *The cost of contesting the tax liability should be deductible under Section 23(a).*

AT PRESENT, under Section 23(a) of the Internal Revenue Code and the Regulations, taxpayers may deduct expenses incurred in determining tax liability, including fees paid in connection with the preparation of tax returns and tax litigation, but only if the expense is incurred in the production or collection of income, or in the management, conservation or maintenance of property held for the production of income. This provision does not go far enough. For instance, the courts have recently held that the expense incurred in contesting an alleged gift tax liability does not constitute conservation of property held for the production of income. The legitimate cost of contesting an asserted tax liability should be deductible under Section 23(a) even if there is no property held for the production of income involved.

A wage earner who disputes the tax assessed against him by the Commissioner should be allowed to deduct the cost of contesting that tax liability. That expense is logically a cost of conserving his earned income, and the Code should be amended to provide that the cost of contesting all tax liability be deductible under Section 23(a).

Tax Some Corporations as Partnerships

13 *The Code should be amended to grant the irrevocable option of being taxed as a partnership to a corporation, 50% of whose stock is owned directly or indirectly during the last half of the taxable year by or for not more than five individuals.*

AT PRESENT, under the Code, if the corporate form of doing business has been adopted, the taxpayer must be taxed as a corporation. This is so whether the business involved is a publicly held corporation or is owned and managed by a few persons and their families. Moreover, the great majority of corporations in this country are of the latter category. These corporations do not differ in any respect from their competitors that use the sole proprietorship or the partnership form of organization, except that, of course, they enjoy the limited liability which is a characteristic of the corporation. The similarity of the small, closely held corporation to the partnership is recognized in the tax systems of several foreign countries where corporations are divided into public (widely held) and private (closely held) categories. We should follow their example. It is ony equitable to allow these closely held corporations to be taxed as partnerships. It is recommended that the Code be amended to grant the irrevocable option of being taxed as a partnership to a corporation, 50% of whose stock is owned directly or indirectly during the last half of the taxable year by or for not more than five individuals. However, to prevent abuse of the option it should be irrevocable.

Revise Definition of Fiscal Year [48(b)]

14 *The definition of "fiscal year" should be extended to include annual accounting periods consisting of multiples of weeks instead of months (such as 13 four-week periods, etc.).*

USE OF four- and five-week periods rather than monthly accounting periods has been consistently followed by many trades and industries in an effort to make more accurate cost distributions, and financial comparisons, which would otherwise be disturbed by use of months that vary from 28 to 31 days. It has been the only possible method of accurately reflecting costs in many industries and businesses. In certain businesses, such as meats, groceries and other retail stores, the packing industry, the baking industry, and others, merchandising is handled on a weekly basis, making weekly closing of accounts the only practicable procedure. A natural corollary of this method of accounting is for annual accounting on a thirteen four-week period basis, or by using twelve periods of which eight are four weeks in length, and four are five weeks in length. Under this procedure, determination of the end of the week, or the end of the year, is simply a matter of selecting the most practical day for closing. In most businesses, it is Saturday night of the fourth week. In others, it may be a Monday night, etc. In these cases, an additional week is included in the annual period every five or six years in order to compensate for the difference between an actual year and 52 weeks. Such use of accounting periods, consisting of multiples of weeks, is a common and generally accepted business and accounting practice.

Although these accounting periods do not conform literally to the definition of a "taxable year" or "fiscal year" stated in Section 48(b) of the Code, because the last day of such a period does not usually fall on the last day of a given month, the Commissioner has accepted the return of taxpayers using that method of reporting as a matter of administrative policy. As a matter of fact, the Joint Committee on Internal Revenue Taxation on April 4, 1952, approved this practice when the Commissioner of Internal Revenue appeared before it to report on certain administrative procedures being followed in the Bureau. However, the tone of the Commissioner's statement implied that acceptance of the returns of taxpayers using a weekly basis for the maintenance of records was discretionary with him. Taxpayers are entitled to more certainty and the propriety of their method of record-keeping should not depend on the whim of the Commissioner.

Moreover, the Commissioner's statement only applied to those taxpayers using long-established accounting methods not strictly in conformity with Section 48 (b), and consequently new taxpayers who desire to adopt, or who recently adopted, such method are uncertain as to whether their returns will be accepted without question.

Such methods of accounting by which 52 consecutive weeks (and occasionally 53 weeks) are represented in each fiscal year should be approved by statute. There is no practical reason to the contrary. It is a serious problem for long established businesses, whose accounting methods have been repeatedly approved in Bureau examinations, to have to alter methods of keeping books, reports to stockholders and credit agencies, cost accounting systems and other extremely detailed record-keeping processes if and when the Commissioner decides to strictly interpret Section 48 (b).

The law should be amended *retroactively* to include within the definition of "fiscal year" any annual period consistently employed by the taxpayer, if the taxpayer uses the system of dividing its annual accounting period into four-week periods or four- and five-week periods, instead of calendar months.

Fiscal Year Taxpayers

15

For many years the accounting profession has advocated the adoption of a natural business year for taxpayers engaged in business. As a result, not only corporations but businesses conducted in the partnership or fiduciary form have adopted the fiscal year for both accounting and tax purposes. The Treasury Department has benefited in that the use of fiscal years has spread the handling of returns throughout the year.

Most individuals who may be members of partnerships or trusts which report on a fiscal year basis have continued to report their individual income on a calendar year basis. For a number of years such individuals have included in their returns for the calendar year their distributive share of the income of the partnership or trust for its fiscal year ending within the calendar year.

The position taken in the Excess Profits Tax Act of 1950, making the Act effective July 1, 1950, and in the Revenue Act of 1951, making rate changes effective April 1, 1951, for all corporate taxpayers and November 1, 1951, for individual taxpayers, irrespective of their fiscal years, is basically inconsistent with other provisions which do not take effect until taxable years beginning after a specific date. Many inequities have resulted and these changes are suggested to remove such inequities and to prevent further inequities.

When substantial changes are made in individual tax rates, inequities result. For instance, the individual who is a member of a partnership having a fiscal year ended January 31 will pay tax at 1952 rates on his entire income from the partnership even though 11/12ths of such income may have been earned in 1951 when income was taxed at lower rates.

It is recommended that in computing the tax of individuals who have income from partnerships or trusts, such income should be prorated to the respective calendar years and taxed to the individual at the appropriate rates in effect in such calendar years. Such procedure would be comparable to the Section 207 (b) of the Revenue Act of 1926. This amendment should be effective as of January 1, 1950.

In the Revenue Act of 1951, many substantive changes were made in the Internal Revenue Code which had various effective dates, but were generally applicable to taxable years beginning after such effective dates. For instance, Section 319 of the Revenue Act of 1951 changed the depletion rate for coal from 5% to 10%, effective for taxable years beginning after December 31, 1950. A taxpayer having a fiscal year ending on November 30, 1950, would not benefit from the increased depletion rate until its taxable year beginning December 1, 1951, eleven months after the new rate became available to its calendar year competitors. This particular inequity was corrected by P.L. 594 (H.R. 8271) enacted July 21, 1952 but it illustrates the need for a more uniform application of legislative changes.

It is recommended that substantive changes in the tax laws should be made applicable on a calendar year basis and that fiscal year computations shall be on a pro rata basis for the two calendar years involved.

Remove Two Per Cent Tax on Consolidated Returns

16 *The 2 per cent additional tax applicable to consolidated returns should be eliminated.*

There is every justification for taxing an affiliated group of corporations as the single unit which, economically and in practical fact, it is. This has been recognized as sound accounting and business practice for many years. The principle of consolidated income tax returns on an elective basis is sound because thereby the taxable income of an affiliated group is more clearly reflected than by separate return filing. If it is sound to determine the taxable income of an affiliated group on a consolidated basis, filing on that basis should not be penalized. If such filing is desirable, it should not be discouraged. Determination of taxable income on the basis of the actual business entity — as distinguished from the artificial separate corporate entities — should not be regarded as a privilege to be paid for, but as a desirable objective to be encouraged, or, at least, not discouraged.

Amend Section 102

17 *Section 102 should be amended to provide the following:*
a. At taxpayer's option dividends paid after the end of the taxable year, but before the due date (original or extended) of the tax return, should be allowed as a credit in computing undistributed Section 102 net income.

b. In the event of imposition of surtax under Section 102, the corporation should be permitted to relieve itself of such tax, in whole or in part, by a deficiency dividend under conditions and procedure now prescribed in Section 506 for personal holding companies, or, alternatively, by filing consent dividend papers, as provided in Section 28, effective as of the original taxable year.

c. That the Commissioner has the burden of proof of showing that the profits of a corporation have been accumulated beyond the reasonable needs of the business.

High corporate profits during recent years combined with high individual tax rates have unquestionably created some situations to which Section 102 should be applied. These are cases in which the accumulation of earnings in the corporation is clearly beyond all reasonable needs of the business and is motivated by a purpose to save taxes to the shareholders.

In many other cases, however, corporations with a temporary, highly abnormal liquidity find themselves under powerful silent pressure from Section 102 to pay dividends when considerations of normal business prudence would require conservation of these funds for additions to and replacements of facilities, expansion, protection against possible business decline, or other valid purposes. The increasing tendency reflected in some court decisions to restrict justification for retention of earnings to business requirements which are imminent and definite, as well as the fact that the burden of justification of retaining earnings is on the taxpayer, exerts pressure toward unsound dividend policy. Directors, acting in good faith and using their best judgment, may find their judgment held to be erroneous by the Commissioner or by the courts (who have the benefit of hindsight) and thus be exposed to minority stockholders' actions.

This pressure and the uncertainty which it creates in the formulation of sound business policy is the most unfortunate feature of the present situation.

Under our present system of taxing dividends, the principle of Section 102 is undoubtedly necessary. It would appear that assurance of a wise and sympathetic administration of the Section is equally necessary. Announcement of an administrative policy to apply Section 102 only in clearly flagrant cases, or where dividend history over a number of years clearly indicates tax-motivated non-distribution of earnings, and that the taxpayer would receive the benefit of any reasonable doubt, might help considerably to relieve existing confusion and uncertainty.

At present, Section 102 (c) places the burden of proof on a corporation to show by a clear preponderance of the evidence that any unreasonable accumulation of profits beyond the reasonable needs of the business is not for the purpose of avoiding surtax upon its shareholders. This section places a difficult, if not impossible, burden on many corporations. The standard used in the section — the unreasonable accumulation of profits — is one of the most tenuous in the Code. Profits needed to be retained for the reasonable needs of any business can hardly be objectively defined. The right amount is purely a matter of business judgment and authorities vary markedly in their views as to how much should be prudently retained by any business. Certainly, the vast majority of corporations do not allow tax avoidance considerations to influence their distribution of profits to shareholders. These corporations should not be compelled to carry the burden of proof contemplated by the section. For the relatively few instances where Section 102 clearly needs to be involved, the Commissioner should be able to meet the burden of proof of showing the need for the penalty. The section should be amended to shift the burden of proof from the taxpayers to the Commissioner.

Personal Holding Company Gross Income

18 *For the purpose of Subchapter A, dealing with Personal Holding Companies, gross income from the sale of products or services should be defined to mean "gross receipts" from sales.*

SUBCHAPTER A of the Code subjects certain undistributed net income of personal holding companies to substantial taxes in addition to those levied by Chapter 1. The test as to whether a company is to be subjected to that additional surtax depends upon whether 70% or 80% (depending on certain factors) of its *gross income* for the taxable year is personal holding company income. Under this test, if a company had substantial income from the sale of products or services as well as from those activities which generate personal holding company income (i.e., dividends, interest, personal service contracts, stock, securities and commodities transactions, etc.), but if it has a gross loss on its sales, and therefore no gross income therefrom, even a very small amount of personal holding company income would be more than the required 70% or 80% of gross income, requiring the levying of the surtax. This is inequitable and can be corrected by defining gross income from sales, for the purpose of Subchapter A, as "gross receipts" from sales. This amendment should be made applicable retroactively to all open years.

Revise Rules for Personal Holding Companies

19 *Recommendations with respect to personal holding companies*

(a) Effectuation of deficiency dividends by consent dividend procedure should be authorized. Often the finances of the corporation at the time of determination of a personal holding company tax deficiency are such that the payment of a cash dividend to take up the prior deficiency is not possible without seriously disturbing the corporation's financial status. Such a cash deficiency dividend is utterly impossible where the corporation has previously been liquidated. This can be remedied by amending the statute to permit the application of the consent dividend provisions to deficiency dividends.

(b) Deficiency dividend procedure should not be denied in cases of non-fraudulent delinquency in filing personal holding company tax returns. The provisions of Section 506 (f) denying the benefit of the deficiency dividend credit if the final determination of deficiency contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or failure to file the return within the proper time, unless it is shown that such failure is due to reasonable cause and not to willful neglect, should be modified and confined to fraud cases. In many cases personal holding company tax returns have, inadvertently and innocently, not been filed, either because of ignorance, or because of failure to recognize the effect of certain technical provisions, or because of changes in administrative or judicial interpretation of the provisions defining personal holding companies. In some cases changes made by Internal Revenue Agents have caused taxpayers to fall within the personal holding company classifications when clearly, prior to such changes, the filing of personal holding company returns would not have been required. In many such cases, the Commissioner of Internal Revenue has been sustained in his claim that the taxpayer has not shown that the failure to file the return on time was due

to reasonable cause and not due to willful neglect, including cases where the fault, if any, lay with the taxpayer's adviser and not with the taxpayer.

Because the cases involving delinquency penalties as a general rule are not serious and involve no element of fraud, the further penalty of a denial of the right to the deficiency dividend credit is unjust. The aggregate penalties might well exceed the fraud penalty in the case of an ordinary corporation. Hence, it is urged that the provisions of Section 506 (f) be limited to cases in which all or part of the deficiency is due to fraud with intent to evade tax.

(c) The deduction of the federal income tax, in computing undistributed Subchapter A net income, should be clearly stated to be the tax for the taxable year, whether the corporation is on the cash basis or the accrual basis. Under present law the deduction allowed for federal income tax, in computing undistributed Subchapter A net income, is the tax paid or accrued during the taxable year, depending on the taxpayer's method of accounting. In the case of a cash basis corporation the deduction is for any such taxes actually paid during the taxable year, generally consisting of the tax for the immediately preceding year and/or any deficiencies paid for still earlier years. In the case of such a cash basis corporation, which is either newly formed or which had no income tax for the preceding year, the total tax can and frequently does exceed 100 per cent: e.g., on a $100,000 net income (undistributed), to a cash basis taxpayer the income tax would be $46,500, and the personal holding company tax $84,800, or a total of $131,300.

"Gross Receipts" of Subsidiary [23(g)(4)]

20 *For the purpose of Section 23(g)(4), which excludes from the capital loss category loss from worthlessness of stock in a virtually wholly owned subsidiary of a domestic corporation, if more than 90 per cent of the subsidiary's gross receipts for its entire history was from other than investment sources, gross income from the sale of merchandise, stock in trade, or property held primarily for sale to customers in the ordinary course of the trade or business should be deemed to mean "gross receipts" from such sales.*

BROADLY SPEAKING, it was the purpose of Section 23 (g) (4) to permit an ordinary loss deduction for loss from worthlessness of stock in a bona fide operating subsidiary, with no substantial investment income. This purpose is defeated where the subsidiary's operations are so disastrous that it has a gross loss on its sales, and therefore no gross *income* therefrom, since in such case an utterly insignificant amount of investment income would be more than 10 per cent of the gross income and would remove the case from Section 23 (g) (4), requiring treatment of the loss as a capital loss. This should be remedied by defining gross income from sales, for this purpose, as "gross receipts" from sales. This amendment should be made applicable retroactively to all open years.

Enlarge Definition of Business Bad Debts [23(k)]

21 *Section 23(k) of the Internal Revenue Code should be amended to exclude from the definition of non-business bad debt those debts which arise in the course of a taxpayer's trade or business, or which represent loans or advances to business organizations in which the taxpayer has a financial interest either as an employee, stockholder, or creditor.*

THE PRESENT statutory definition of non-business bad debt has been interpreted by the Treasury Department to include those debts which arose in the course of a trade or business but which at the time of worthlessness are not directly connected with a trade or business of the taxpayer suffering the loss. Classification on the basis of circumstances when the debt was incurred would be a more equitable test.

Furthermore, considerable controversy and litigation has ensued as to the classification of bad debts incurred by employees and investors on loans and advances to business organizations by which they are employed or in which they have a financial interest. The present attitude of the Treasury Department puts a premium on form rather than on substance, and inhibits necessary flexibility of business dealings.

The proposed amendment should be effective for all open years.

Contributions to Non-Exempt Employees' Trusts [23(p)]

22 *The Internal Revenue Code should be amended to provide that taxpayers making contributions to a profit-sharing or pension trust not exempt under Section 165 should be allowed a deduction from net income for such payments in the year the amounts are paid to the employee by the trust even though the rights of the employee were forfeitable when the contributions were made.*

An employer is allowed to deduct his contributions to an employees' pension trust or annuity plan as provided in Section 23 (p) even if the trust to which the contributions are made is not tax exempt under Section 165 (a), provided the rights of the employee under the plan are not forfeitable when the contribution is made. However, if the employees' rights are forfeitable, the taxpayer is not allowed a deduction in any taxable year as provided in the regulation, Section 29.23 (p) (11), Reg. 111.

This limitation forbidding the deduction in any taxable year is inequitable, and it is recommended that the Code should be amended to provide that when contributions are made to a profit-sharing or pension trust not exempt under Section 165, and the rights of the employee are forfeitable when the contributions are made, the taxpayer be allowed a deduction – subject to the limitations of reasonableness outlined in Section 23 (a) – in the year the amounts are paid to the employee by the trust.

It is recognized that the employee should be required to report as income only the portion of the distribution which was not previously taxed to the trust, and that the employer should be allowed a deduction only for the portion of the distribution which is taxed to the employee. However, the exact procedure for the allocation should be defined in the Regulations.

Payments to Employees' Pension and Profit-Sharing Plans [23(p)(1)(E)]

23 *A taxpayer on the accrual basis shall be deemed to have made a payment under Section 23(p) on the last day of the year of accrual if the payment is on account of that taxable year and is made up to the time of the due date for the filing of the return for that taxable year, including any extension of time for filing the return.*

UNDER Section 23 (p) (1) (E), an accrual basis taxpayer, making contributions to an employees' pension or profit sharing plan, shall be deemed to have made a payment on the last day of the year of accrual if the payment is for that taxable year and is made within sixty days after the close of the taxable year of accrual. The computation of the amount allowable as a deduction under Section 23 (p) may be extremely complicated. It is frequently necessary to assemble voluminous payroll data and make involved actuarial computations before the amount required to be paid can be accurately determined. In the case of a profit-sharing plan, the amount required to be paid may not be determinable until an independent audit of the books has been completed. While the sixty-day period of grace has been helpful, experience has shown that it is inadequate in many cases. As a consequence, the employer taxpayer usually finds it necessary to make a timely payment of an estimated amount, resulting either in an underpayment which is not deductible until the succeeding year or years, or an overpayment which may not be recoverable.

Since Congress has deemed it necessary to place many restrictions upon the deduction allowable under Section 23 (p), it is equally fitting that the taxpayer should be allowed adequate time to compute and apply such restrictions. Accordingly, it is recommended that the period be extended to allow the payment to be made up to the due date of the return, including any extensions of time for filing the return.

Basis After Sale at Loss to Related Taxpayer [24(b)]

24 *When loss on the sale of property is disallowed by reason of the relation of the parties, the subsequent basis of the property for purpose of determining gain should be the transferor's basis.*

SECTION 24 (b) of the Internal Revenue Code provides that, in computing net income, no deduction shall be allowed in respect of losses from sales or exchanges of property directly or indirectly, (a) between members of a family; (b) between an individual and a corporation in which he owns (actually or constructively) more than fifty per cent of the outstanding stock; (c) between two corporations when more than fifty per cent of the outstanding stock of each is owned by or for the same individual; and, in the case of trusts, between (d) grantor and fiduciary, (e) beneficiary and fiduciary of trusts, or (f) trusts themselves, if created by the same grantor.

Under present law, if the purchaser in such a transaction thereafter sells at a price higher than he paid, though less than the transferor's cost, taxable gain results. This offends the general principle, applied in many other sections of the Code, that transactions resulting in no recognized gain or loss shall not affect the tax basis of the property.

The Code should be amended to provide that the rule applicable to gifts be applied to such properties and that, for the purpose of determining gain, the cost or other basis of the transferor be the basis to the transferee, but for the purpose of determining losses the basis be limited to the value at the date of transfer. The amendment should also provide that the holding period under Section 117 of the Code, in case of gain, shall include the holding period of the transferor.

Unpaid Expenses Under Section 24(c)

25 *The limitations of Section 24(c) should not apply to deny deduction to an accrual basis taxpayer of unpaid expenses and interest if the person to whom the payment is made elects at any time within the statutory period of limitations with respect to the taxable year of the payor to include such payment as income in a taxable year beginning not later than the end of the taxable year of the payor during which the payment accrued.*

SECTION 24 (c) disallows to a taxpayer on the accrual basis all deductions for unpaid expenses and interest which are payable to related interests who are on a cash basis unless the payment is made during the taxpayer's taxable year or within two and one-half months after the close of such year. The purpose of this Section is to prevent a taxpayer claiming a deduction for expenses or interest payable to a related interest where the latter is not required to include the items as income.

It has been held in a number of cases that the deduction was not allowable even though the related interest, on a cash basis, was required to include the expenses as income because "constructively received."

Section 24 (c) should be amended to provide that such section shall not apply where the person to whom the payment is made elects at any time within the statutory period of limitations with respect to the taxable year of the payor to include such payment as income in a taxable year beginning not later than the end of the taxable year of the payor during which the payment accrued. This amendment should be made retroactive to all open years.

Accrued Deductions Upon Liquidation [42(a)]

26 *If, upon liquidation, a cash basis corporation is required to recognize accrued income, it should also be permitted to recognize accrued deductions.*

THE TREASURY DEPARTMENT has interpreted Section 42 (a) in such a way that a cash basis corporation being liquidated is required to recognize accrued income. However, that same corporation is not permitted a deduction for its expenses and losses unless it actually pays them. This treatment is inconsistent. It is recommended that if, upon liquidation, a cash basis corporation is required to recognize accrued income, it should also be permitted to pick up deductible accrued expenses and liabilities.

Liberalize Qualification of Instalment Sale [44(b)]

27 *The Code should be amended to provide that the absence of any payments in the year of a sale of realty or a casual sale of personalty will not prevent the transaction from being an instalment sale.*

AT PRESENT, in order for the instalment method to be applied there must be at least two payments, and one of those payments, in cash or property, must be made during the year in which the sale occurred. A mere promise to pay, or other evidence of indebtedness, during the year of the sale with the actual two or more instalment payments occurring in later years is not in compliance with the statute, and the instalment method may not be used in such a case.

The committee urges amendment of the Code to permit use of the instalment method when all the other requirements have been met even though there is no actual payment in the year of the sale. There are many legitimate transactions which cannot be reported under the instalment method merely because there was no payment in the year of sale. It is inequitable to make the right to the instalment method depend on the necessity of the initial payment during the year of sale, when a transaction otherwise is in perfect conformity with the requirements of the statute. Accordingly, it is recommended that the provision in Section 44 (b) regarding instalment sales should have reference to initial payments "if any," so that the absence of any payments in the year of sale will not prevent the transaction from being an instalment sale.

Change to Instalment Basis [44(c)]

28 *Taxpayers changing from the accrual to the instalment basis of reporting income should be granted a limited credit for the tax already paid on the portion of their income which was reported under the accrual basis in earlier years.*

TODAY, if a taxpayer elects to change his method of reporting income from the accrual to the instalment basis, in computing his income for the year of the change and subsequent years, he is required to include profit attributable to amounts received in such year for sales made in prior years even though the entire profit on those sales had been reported on the accrual basis, and tax paid thereon. The inequitable result is double taxation. This situation should be cured and it is recommended that the Code be amended to grant taxpayers changing from the accrual to the instalment basis a limited credit for the tax already paid on the portion of their income which was reported under the accrual basis in earlier years. The credit should be that part of the tax paid that the accrued income was to the total income in the year of accrual. The credit should be subject to the limitation that it could not exceed the similar proportion of the current tax, based on the relationship between the instalment gain and the total income.

Successor Corporation in Tax-Free Reorganization [112, 113]

29 *Where a corporation is formed or availed of to acquire the assets and become the successor, in a tax-free reorganization, of a predecessor corporation, which, in pursuance of the plan, is liquidated and dissolved, the successor corporation should step into the "tax shoes" of the predecessor corporation.*

UNDER Sections 112 and 113 of the Code, property acquired by a corporation in certain types of corporate reorganization has the same basis for tax purposes as in the hands of the predecessor company. The underlying theory is that the successor steps into the "tax shoes" of the predecessor company. This theory, however, has not been extended beyond the basis of property except with respect to the status of life insurance as provided in Section 110 of the Revenue Act of 1942. Thus, the Commissioner has not conceded that net operating losses of the predecessor can be carried forward against income of the successor, or vice versa. Interest paid on additional taxes asserted against the predecessor can be deducted by the successor only to the extent accrued since the date of the reorganization, except possibly in the case of statutory mergers or consolidations. The tax benefit rules provided in Sections 22 (b) (12) and 127 of the Code with respect to recoveries on bad debts or taxes or losses or other items previously claimed or allowable to the predecessor is not extended to the successor. Other items of expenses paid by the successor on account of the predecessor, which would have been deductible by the predecessor had it continued in existence, are not allowed as deductions to the successor.

In addition, the successor is not now permitted to step into the "tax shoes" of the predecessor company regarding pension contribution and credit carry-overs, capital loss carry-overs, the unused excess profits credit carry-backs and carry-overs under the Excess

Profits Tax Act of 1950, inventory replacement in the case of involuntary liquidation, and amortization of emergency facilities.

This should be corrected by providing that the successor in such cases succeeds to the tax status of the predecessor for the purpose above mentioned with appropriate safeguards where necessary in the case of carry-backs.

The principle asserted above should be made applicable to all transactions recognized as tax free under Section 112 of the Internal Revenue Code, including complete liquidations of corporations under Subsection 112 (b) (6). The corrective amendment should be made applicable retroactively to all taxable years not barred by limitation or closing agreement.

Sale of Corporate Assets Followed by Liquidation [112]

30 *The Code should be amended to provide that in the case of the sale of all the assets of a corporation followed by the liquidation of the selling corporation within a reasonable period of time, no gain or loss should be recognized by the selling corporation if the transaction is part of a plan to sell its assets and liquidate completely.*

At the present time, if the shareholders of a company wish to dispose of the business, the form of the transaction, i.e., sale of all of the capital stock or of all of the corporation's assets, followed by liquidation of the corporation, produces different tax results. In the case of a sale of the stock, only one tax is imposed, whereas a sale of assets results in two taxes, one on any gain realized by the corporation, and another to the shareholders upon liquidation of the corporation. Since from a practical point of view the net result is the same, namely that the stockholders receive the net proceeds of the sale of the business, it is inequitable to let the mere form of a transaction produce such divergent tax results. Accordingly, it is recommended that in the case of the sale of all the assets of a corporation followed by the liquidation of the selling corporation within a reasonable period of time, no gain or loss should be recognized by the selling corporation if the transaction is part of a plan to sell its assets and liquidate completely.

In the alternative, the corporate purchaser of all of the capital stock of a corporation which is promptly thereafter liquidated should be allowed to treat the purchase price of the stock as the cost basis of the assets thereby acquired.

Nonrecognition of Gain in Corporate Liquidations [112(b)(7)]

31 *Section 112(b)(7) should be amended to include liquidations made after 1952. The election privilege should be allowed up to the time of the filing of the return for the taxable year involved and should be made effective for years beginning after December 31, 1950.*

SECTION 112 (b) (7) provides for an election as to recognition of gain in certain corporate liquidations when the distributions in liquidation were made in 1952. In recent years, the benefits of the section have been brought forward to cover specific years, but the section has never been amended to allow the election generally. The principle of the election is well established, and there is need for the election for distributions in liquidation made in years subsequent to 1952. Accordingly, Section 112 (b) (7) should be made a permanent part of the Internal Revenue Code.

Section 112 (b) (7) (D) requires that shareholders desiring to enjoy the benefits of the section file a written election within thirty days after the adoption of the plan of liquidation. The present requirement is too rigorous and does not allow enough time for many taxpayers desiring to enjoy the advantages of Section 112 (b)

(7) to inform themselves about the plan. It is recommended that shareholders, or the liquidating corporation, be allowed to exercise the election privilege up to the time of the filing of the return for the taxable year involved. This needed correction should be made effective for years beginning after December 31, 1950.

Transfer of Assets in a Reorganization [112(g)(1)(C)]

32 *A transfer of substantially all the assets of a corporation to another corporation should not be disqualified as a "reorganization" under Section 112(g)(1)(C) merely because the voting stock received in exchange is that of a parent company of the transferee corporation.*

In *Groman* v. *Commissioner,* 302 U.S. 82 and *Helvering* v. *Bashford,* 302 U.S. 454, the Supreme Court held that where all the assets of one corporation were transferred to another company for its stock, and such properties were then transferred to the subsidiary of the company issuing the stock (or were transferred directly to such subsidiary in the first instance), the company issuing the stock was not a "party to the reorganization" and the receipt of its stock by the shareholders of the company whose properties were acquired was a taxable exchange — and not, as in most mergers, an exchange on which gain or loss is not recognized. Such transfers should qualify as tax-free reorganizations to the same extent as if the stock-issuing company had no subsidiary and retained the properties itself — the transfer to such subsidiary being purely an internal arrangement of the stock-issuing company. This condition can be remedied by extending the term "party to a reorganization" to include the parent corporation owning all of the stock of a corporation to which the properties are transferred.

Net Operating Loss Deduction [122(d)(5)]

33 *Section 122(d)(5) provides (for taxpayers other than corporations) for allowance of losses in the computation of net operating loss deduction only if they are attributable to the operation of a trade or business regularly carried on by the taxpayer. The Section should be amended to provide for recognition in the computation of net operating loss deduction of losses on disposal of assets used in a trade or business by a non-corporate taxpayer.*

IN I.T. 3711 the Treasury Department ruled on the matter of computation of net operating loss deduction of an individual taxpayer who sold at a loss several parcels of real estate operated by her as a source of income. The Department held that such losses were deductible in full by the taxpayer as ordinary losses since the assets constituted property used in trade or business. However it held that the losses were not includible in computation of net operating loss deduction (except to the extent of non-business gross income) on the grounds that while the taxpayer was in the business of operating real estate, she was not in the business of selling real estate. The courts have taken the same position on several occasions.

It seems reasonable to maintain that operating a business comprehends purchasing and selling the related assets, and that losses on sale of such assets are business losses, even if all of the assets are old and the taxpayer ceases to conduct business. Such losses are presently allowable in determining net operating loss for corporate taxpayers. Section 122 (d) (5) should be amended by striking out the words "the operation of" so that the section would not apply to any deduction attributable to a trade or business regularly carried on by the taxpayer.

The amendment should be effective retroactively for all open years.

In support of the asserted position, it should be noted that the report of the Committee on Ways and Means in amplification of the non-business bad debt provision of the 1942 Act, stated that "a loss incurred in liquidating a business is a proximate incident to the conduct of a business."

Statute of Limitations When Gross Income is Omitted [275(c)]

34 *The five year statute of limitations should not be applied, even if more than 25% of gross income is omitted from a return, provided that there was adequate disclosure of the omitted item in the return.*

UNDER THE provisions of Section 275 (c), if a taxpayer omits an amount properly includible in gross income which is more than 25% of gross income, the tax may be assessed, or a court proceeding for the collection of the tax may be begun within five years instead of three. The lengthening of the statute of limitations is an appropriate penalty when gross income is improperly understated. However, there are instances when the application of the penalty is needlessly harsh. For example, a difference of opinion between the taxpayer and the Bureau as to when an item of income is taxable, or whether it is taxable at all, (even though it is disclosed in the return) may result in the imposition of the longer statute of limitations, with attendant inconvenience for the taxpayer. This situation can be fairly remedied, and it is recommended that the five year statute not be applied, even though there is an omission of more than 25% of gross income, provided there has been adequate disclosure of the omitted item in the return. Such disclosure should show the amount, source and nature of the omitted item. In this way, the Commissioner would be provided with all the information needed to protect the revenues, and the taxpayer would not be subjected to unnecessary penalty.

Limitation on Amount of Credit on Refund [322(b)(3), (4)]

35 *Where a claim for credit or refund is filed within three years of the filing of the return, it should apply to all amounts paid prior thereto with respect to that year even though the claim is filed more than three years from the time of payment of the tentative tax.*

At present, unless a claim for credit or refund is filed within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, no credit or refund shall be allowed or made after the expiration of the later of those two periods. However, when a taxpayer obtains an extension of time for filing the return, pays a tentative tax on the original due date, and files the final return at some later time, the beginning of the three year period for the purpose of filing claims for credit or refund is considered to be the date on which the return was filed. The effect of this provision is to limit the amount of a claim for credit or refund to the amounts paid within the defined period.

This is inequitable. An extension of time for filing the return postpones the beginning of the three year period for the assessment of deficiencies under Section 275 (a). The taxpayer should not be penalized by shortening the period of time within which claims for credit or refund may be filed, and limiting the amount of his claim, when he makes a timely payment of the tax estimated to be due.

It is recommended that where a claim for credit or refund is filed within three years of the filing of the return, it should apply to all amounts paid prior thereto with respect to that year even though the claim is filed more than three years from the time of payment of the tentative tax.

Interest on Deficiencies and Overassessments [3771]

36 *The provisions of the code with respect to interest on deficiencies and overassessments should be amended to provide for consistent and more equitable treatment between deficiencies and overassessments.*

THE PROVISIONS of the Internal Revenue Code dealing with the allowance of interest on overassessments (refunds) contained in Section 3771 provide a general rule that interest on overpayments (overassessments) shall be allowed at the rate of 6 per cent:

a. *In the case of a credit;* from the date of the overpayment to the due date of the amount against which the credit is taken, but if the amount against which the credit is taken is an additional assessment, then to the date of the assessment of that amount.

b. *In the case of a refund;* from the date of the overpayment to a date preceding the date of the refund check by not more than thirty days, such date to be determined by the Commissioner.

This inequity is illustrated by the following common example. Whenever an item of income or deduction is shifted from one taxable year to another as a result of a Revenue Agent's examination creating a deficiency in one year and an overassessment in the other, and the original tax has been paid in instalments, interest adjustments are made as follows:

a. Upon the deficiency, interest is computed from the date the original return was due, namely on the fifteenth day of the third month following the close of the calendar or fiscal year.

b. On the other hand, interest on the overassessment is computed from the time the tax is overpaid. If the entire overpayment is applicable to the last installment (*Blair* v. *Birkenstock,* 271 U.S. 348; C.B. V-1, 142), interest is computed from the fifteenth day of the twelfth month following the close of the calendar or fiscal year. The taxpayer, under the circumstances, is overcharged to the extent of nine months' interest on the refund, purely on the basis of theoretical, if not arbitrary, bookkeeping.

The provisions of the code with respect to interest on deficiencies and overassessments should be amended to provide for consistent and more equitable treatment between deficiencies and overassessments.

Easing Effects of Statute of Limitations [3801]

37 Recommendations re mitigation of effect of statute of limitations.

THE PURPOSE of Section 3801 was to mitigate the effect of the statute of limitations since "It was never intended that the statute of limitations should have the result of allowing either taxpayer or Commissioner to reap a double advantage from its operation by assuming in one year a position inconsistent with that taken in a barred year."

Section 3801, as enacted, has limited application since (1) only income and profits taxes under Chapter 1 and Subchapters A, B, D and E of Chapter 2 may be involved, (2) the error and the determination, as defined by Section 3801 (a), must relate to the same type of tax as enumerated in (1) above; (3) the determination and error must relate to the situations specified in Section 3801 (b). These limitations restrict the benefits to be derived from this Section and do not relieve the hardship in many meritorious situations, those falling outside these specific types of cases continuing to rest on general principles. For example, if the Commissioner shifts an item of income from a barred year to an open year, or a deduction from an open year to a barred year, the taxpayer in equity and good conscience should be entitled to a refund for the barred year. The Commissioner at present has no power to grant the refund. Another class of situation involves an adjustment for one taxpayer because of another taxpayer's error.

The law should be amended to cover the following:

1. When a deduction is made in good faith on the tax return of one year and is disallowed by the Commissioner on the ground that it was deductible in a return of a different year.
2. When income is included by the taxpayer in good faith in one year and is held by the Commissioner to be taxable in another year.
3. When the basis of an asset claimed by taxpayer is reduced by the Commissioner for the purpose of computing net income of one year on the ground that the reduction of the basis should have been made in another year.
4. When income or deductions are included or deducted by one member of an affiliated group, as defined in Section 141 (d), and are allocated by the Commissioner to another member of the group.
5. When income or deductions are included in good faith in the tax return of one taxpayer but are adjusted by the Commissioner because of another taxpayer's error.
6. When income or deductions are included in good faith on the tax return of one taxpayer and adjustments are made by the Commissioner in respect to a related taxpayer under the provisions of Section 45.

Basis of Property Acquired by Gift

38 *The basis of propery, acquired by gift but subjected to estate tax in the estate of the donor, should be the same as in the case of property passing by death and not previously made the subject of a gift.*

IN MANY CASES all or some portion of property held by the decedent as a joint tenant or tenant by the entirety, and property previously transferred by the decedent by gift or in trust, is required to be included in the estate of the decedent for estate tax purposes.

If property is treated, for estate tax purposes, as though it had passed on death, the basis thereof for income tax purposes should be the same as if it had passed on death, namely, the value at which subjected to estate tax. Under present law, though subjected to estate tax, the property's basis for income tax purposes remains the frequently lower cost to the decedent-donor, so that upon a sale of the property at the estate tax valuation, there is also an income tax to be paid.

Mortgaged Property Bid in By Creditor

39 *Where the holder of a mortgage or other debt forecloses on the security or collateral, and himself bids in the mortgaged or pledged property, the fair market value of the property thus bid in should be treated as a payment on account of the debt, and the deductibility and time of deductibility of the balance of the debt should be determined under the usual rules applicable to deduction of debts worthless in whole or in part.*

UNDER PRESENT Bureau regulations where a creditor bids in mortgaged or pledged property, the transaction is split into two elements: (1) the portion of the debt which was applied to the satisfaction of the bid price is compared with the fair market value of the property, with resulting gain or loss — sometimes claimed to be capital gain or loss (in one case where not only principal, but also interest on the debt, was applied towards satisfaction of the bid price, the Supreme Court held that interest income resulted); (2) the deductibility of the balance of the debt, not applied to the bid price, is determined under the usual rules relating to debts worthless in whole or in part, depending upon whether there is enforceable personal liability, other collateral, guarantees, etc. Particularly where it is claimed that the first element results in capital gain or loss, distorted results frequently ensue.

Actually all that has happened is that the creditor has received, as against his investment in the debt, property having a certain fair market value, leaving the balance of the investment in the debt to be recouped. If worthless, this balance should be allowed as an ordinary bad debt deduction and should not be split artificially into two parts, according to the accident of the bid price, which, usually because of absence of competing bidders, frequently fails entirely to reflect true values or the realities of the situation.

Effect of Payments Under Section 16(b) of Securities Exchange Act

40 *Payments required to be made to a corporation by persons subject to Section 16(b) of the Securities Exchange Act of 1934 should be treated for tax purposes as a short-term capital loss, or as an adjustment of the cost of the stock.*

FOR THE purpose of preventing the unfair use of information about the listed securities of a corporation by an officer, director, or holder of 10% or more of its stock, Section 16(b) of the Securities Exchange Act of 1934 provides for the repayment to the corporation of any profits made by such person because of his close relationship to the corporation. A person required to make payment of such profits to a corporation has been denied any tax benefit therefrom on the grounds of public policy. The decision in the recent *Davis* case, 17 T.C. 549, which enunciated that result, is unrealistic and unfair. Most infractions under the section are inadvertent. Taxpayers subjected to the terms of Section 16(b) are sufficiently penalized by being required to repay their profits. Those payments should be treated as a short-term capital loss, or as an adjustment of the cost of the stock.

Excess Profits Tax

RECOMMENDATIONS

EPT — Need for General Relief Provision

41 *There is definite need for a general relief provision to supplement the existing rigid qualifying tests that determine a corporation's eligibility for relief.*

THE Excess Profits Tax Act of 1950 was intended to provide relief in most of the important cases which were covered under Section 722, the general relief provision of the World War II excess profits tax law . Under that section, when the taxpayer established that its tax computed under the general rules was discriminatory, it was allowed to establish a hypothetical base period earnings credit for the purpose of recomputing its tax liability. Section 722 was subjected to criticism on the ground that it depended too much on administrative discretion in its operation and that it was not administered in the spirit intended when it was enacted. Unfortunately, the present excess profits tax law goes to the opposite extreme and permits little discretion in determining eligibility for relief because the requirements for relief eligibility are precisely defined. Accordingly, those taxpayers that qualify are accorded some measure of relief. However, if a taxpayer fails to fit into the rigid definition, even by the narrowest margin, it may not obtain any relief. This seems inequitable to the committee on federal taxation. The present relief provisions are too narrow in setting the qualifications for relief eligibility. Therefore, the committee recommends that the Excess Profits Act of 1950 be amended to include at least all the same qualifying factors for relief as were contained in Sections 722(b) and (c) of the old law.

Any corporation which can show substantial compliance with the qualifying factors should be entitled to recompute its excess profits credit according to the applicable formulae based upon industry rates of return. Reference is made to the committee's Recommendation Number 56 regarding such rates of return.

Irrevocable Elections

42

THE committee on federal taxation opposes irrevocable elections in the excess profits tax provisions of the Internal Revenue Code. Such elections are manifestly unfair in that the taxpayer must frequently make an irrevocable choice before it possesses all the information required to enable it to make a well considered decision. Moreover, the taxpayer that engages competent tax advisers is in a more advantageous position than another taxpayer that cannot obtain or does not appreciate the need for adequate tax advice.

a. Historical Invested Capital Method

The irrevocable election required by Section 437(b)(1) in order to compute invested capital under the historical invested capital method provided in Section 458 is unfair, and should be changed to allow the taxpayer to make a revocable election.

Under Section 437(b) (1), if the taxpayer elects on its return for the taxable year to compute its invested capital under the provisions of Section 458, the invested capital of the taxpayer for such year shall be determined under the historical invested capital method.

A separate election must be made for each taxable year, and an election once made is irrevocable with respect to the taxable year. The annual election provided in this section requiring the corporation to elect as between the historical capital method and the asset approach is unfair and inequitable.

The inequity of such an irrevocable election is dramatically illustrated by the fact that in some cases the historical invested capital under the previous excess profits tax law is still being litigated, and is as yet undetermined.

The inequity is further illustrated by the fact that a bank which may have made an irrevocable election to use the historical method may not now enjoy the relief intended by Section 438(g), which was added by the Revenue Act of 1951 and retroactively changed the method of computation of the invested capital under the asset approach in case of banks. Even though the asset approach would now be more favorable, the bank was given no right to reconsider or revise its election.

An additional reason is that the minimum credit of $25,000 was intended to relieve the corporation of any necessity of making an accurate determination of the invested capital credit when excess profits net income for the current year is less than $25,000. Under such circumstances it is unfair to require an irrevocable election as between the two methods of determining an invested capital credit which may not become important until some years later when the proper amount of an unused excess profits credit carry-over may affect the tax liability.

Therefore it is recommended that the taxpayer be permitted to elect the historical invested capital method, but that the election not be irrevocable.

b. Net Operating Loss Deduction

Under Section 433(a)(1)(j), the election to compute the net operating loss deduction by taking the "base period" loss adjustment as the net operating loss carry-over from the last taxable year which ended before July 1, 1950 should not be irrevocable.

Under Section 433(a) (1) (j) (iii), if the excess profits credit for the first excess profits tax year was computed by use of the "average earnings" or the "historical invested capital" method, the taxpayer could have elected in its return, for that first taxable year (1950), to compute its net operating loss deduction for all taxable years by taking the "base period loss adjustment" as its net operating loss carry-over from the last taxable year which ended before July 1, 1950.

Under this subparagraph, the election had to be made in the 1950 return even though such net operating loss deduction was not usable in 1950, and it was uncertain whether it would be usable in 1951. Therefore, it is recommended that the taxpayer be permitted to elect the benefit of Section 433(a) (1) (j) (iii) but that the election not be irrevocable.

Determination of Unused Excess Profits Credit [432(b)]

43 *The unused excess profits credit should be determined without the allowance of the net operating loss deduction as provided for in Section 23(s), but only as to net operating losses arising in years prior to excess profits tax.*

SECTION 432(b) defines the unused excess profits credit to be the excess, if any, of the excess profits credit for any taxable year ending after June 30, 1950, and beginning before July 1, 1953, over the excess profits net income for such taxable year, computed on the basis of the excess profits credit applicable to such taxable year and computed *without* the allowance of any deduction under Section 23(s), relating to net operating losses.

The denial of the deduction under Section 23(s) for this purpose should be limited to net operating losses arising in years prior to excess profits tax. The present provision also denies the deduction of net operating losses arising during excess profits tax years and results in inequities between corporations. A corporation which has profits and losses during the period of years subject to the excess profits tax may be required to pay more excess profits tax than another corporation having steady profits aggregating the same amount. The suggested change would permit a more equitable matching of profits and losses during excess profits tax years against the excess profits credit for such years within the limitations of the present carry-over and carry-back provisions.

Unused EP Credit Applicable to Short Taxable Year [432(c)]

44 *Section 432(c) should be amended to provide that the reduction of the carry-over when an excess profits credit has been carried back or over to a short taxable year should be scaled down.*

PROVISION is now made in the Code for the reduction of an unused excess profits credit originating in a short year (one of less than twelve months). In such a case, the unused excess profits credit allowed is a portion of the excess profits credit computed under the general rule. However, although this reduction is required for an unused excess profits credit originating in a short year, there is no comparable provision for reduction of an unused excess profits credit originating in another tax year and carried forward or back to a short year. Under this situation, a part of the carry-back or carry-over may be lost to the extent that the annualized income of such a short year exceeds the actual income. This inequity should be corrected by amending Section 432(c) to provide that the reduction of the carry-over, when an unused excess profits credit has been carried back or over to a short taxable year, should be scaled down in a manner similar to the method provided for in the last sentence of Section 432(c) (2), which is applicable to a carry-back to a partly taxable year. In other words, the portion of the unused excess profits credit applicable to a short year would be equal to the ratio that the number of days in the short taxable year is to the total number of days in the taxable year.

Interest-Paid Adjustment [433(a)(1)(O)]

45 *The interest paid adjustment should not be used to correct for interest income from loans to a member of a controlled group: instead, it would be preferable to provide for an additional interest received adjustment to be correlated directly with an increase in loans to a member of a controlled group.*

IN THE conversion of normal tax net income into excess profits net income for the taxable year, under the income credit method this section operates to disallow the portion of the interest deduction applicable to the increase in borrowed capital. An increase in loans to a member of a controlled group operates to reduce and may eliminate the need for an adjustment of the interest deduction.

Under Section 435(g) (4) (E) an increase in loans to a member of a controlled group may exceed any increase in borrowed capital and further reduce the excess profits credit. In such a case there is no provision for an offsetting adjustment in the nature of an elimination from excess profits net income of part of the interest received from the member of the controlled group.

It is believed that the interest paid adjustment should not be used to correct for interest income from loans to a member of a controlled group. It would be preferable to provide for an additional interest received adjustment to be correlated directly with an increase in loans to a member of a controlled group, as shown in the following illustration:

Illustration under Section 433 (a) (1) (O)

Average borrowed capital for the year	$200,000	
Borrowed capital at beginning of first excess profits taxable year	100,000	
Interest on borrowed capital for the year	12,000	
Average loans to members of a controlled group for the year		$180,000
Loans to members of controlled group at beginning of first excess profits taxable year		100,000
Interest income on loans to members of controlled group		10,800
Effect on excess profits credit: 75% of increase in borrowed capital	75,000	
Less 75% of increase in loans to members of controlled group	60,000	
Net increase	15,000	
Increase in excess profits credit at 12%	1,800	
Effect on excess profits net ncome for the year:		
Increase in excess profits net income for interest adjustment (Sec. 433 (a) (1) (0)) 75% of 100/200 of 12,000		4,500
Interest received adjustment which should be allowed but is not permitted – 75% of 100/180 of 10,800		3,600
Proper net increase in excess profits net income should be		900

Interest Adjustment [433(a)(1)(0) and 445(b)(1)]

46 *The interest adjustment under Section 433(a)(1)(I) should not be made when average base period net income is computed under Section 445(b)(1).*

For its first three business years a new corporation eligible for relief under Section 445 computes its average base period net income by applying the apropriate base period rate of return to its net capital addition, computed by including borrowed capital at one hundred per cent, and subtracting interest expense for twelve months. The net capital addition as such is not allowed. However, the new corporation's excess profits net income for the excess profits tax taxable year is apparently subject to a further interest adjustment under Section 433(a) (1) (0), amounting in general to the interest on 75 per cent of any increase in borrowed capital.

The application of those two interest adjustments subjects a new corporation to a hardship, and it is suggested that the Code be amended to make it clear that the interest adjustment under Section 433(a) (1) (I) should not be made when average base period net income is computed under Section 445(b) (1).

Abnormal Deductions [433(b)(9) and (10)]

47 *The statutory provisions relating to abnormal deductions should be amended, as follows:*

1. The 5% limitation should apply to the aggregate abnormal deductions and not separately to each class.

2. In any event the "cause" test should be eliminated since a percentage limitation and the "consequence" requirement should be a sufficient limitation for the test of whether deductions are abnormal in character as well as in amount.

3. The statute should be clarified to include as abnormal deductions elements of the cost of goods sold as well as statutory deductions.

UNDER THESE sections, claims, awards, and judgments against the taxpayer, intangible drilling and development costs, casualty losses and other abnormal deductions in the base period years may be disallowed in whole or in part in the determination of excess profits net income for any year in the base period. The result of such disallowance is an addition to excess profits net income in the base years and, consequently, an increased excess profits credit based on income.

The law requires a disallowance of the excess over 115% of the average amount of deductions of such class for the four previous taxable years (with alternative calculation when taxpayer not in existence four previous taxable years), provided that in the base period year the deductions of the class disallowed exceed 5% of the average excess profits net income for all the taxpayer's base period years computed without the disallowance of any class of deduction.

A further limitation is that the disallowance of abnormal deductions is not permitted except where the taxpayer establishes that the increase in the deduction is not (a) a cause or a consequence of either (1) an increase in gross income during the base period or (2) a decrease in the amount of some other deduction in the base period — which increase or decrease is substantial in relation to the amount of the increase in the deductions of such class, or (b) a consequence of a change at any time in the type, manner of operation, size or condition of the business.

Finally, the amount of the deductions disallowed is limited to the excess over the deductions of the same class in the taxpayer's excess profits tax year.

The statutory provisions relating to abnormal deductions should be amended as follows:

The application of a 5% limitation to each class of abnormal deductions is decidedly inequitable. The percentage limitation should be eliminated, but if the 5% figure to eliminate inconsequential or irrelevant amounts is used, it should apply to the aggregate abnormal deductions and not separately to each class. For instance, a corporation might have five classes of abnormal deductions, each constituting 4% of the average excess profits net income or an aggregate of 20%, and still not qualify under present statutory provisions.

In any event the "cause" test should be eliminated. A percentage limitation and the "consequence" requirement should be a sufficien limitation for the test of whether deductions are abnormal in character as well as in amount.

The provisions relating to abnormal deductions deal only with "deductions of any class." In situations arising under the similar World War II provision the benefits of abnormal deductions have been denied where the abnormality consisted of items includible as a part of cost of goods sold as distinguished from items which specifically qualify as statutory deductions under Section 23. Both costs and deductions operate to reduce taxable income and may be abnormal in amount or in character.

Accordingly, abnormal deductions should clearly include elements of the cost of goods sold as well as statutory deductions.

Qualification for Growth Formula [435(e)]

48 *Other than for the exception relating to Section 23(p), the total payroll to be used in determining the test of a growth corporation should include non-cash compensation. The limitation of the growth formula to corporations with assets of less than $20,000,000, as required by Section 435(e)(1)(A)(i), should be eliminated.*

CERTAIN ELIGIBLE corporations which have experienced unusually rapid growth during the base period, or otherwise qualify, may use one of several alternative methods to compute average base period net income. Essentially, the credit under the alternative growth formula is based on income of the last 24 or the last 12 months of the base period, or of such other prescribed periods of 12 months, whichever is highest.

One alternative (section 435(e) (1) (A) herein considered states that to enjoy its benefits:

(a) the taxpayer's total assets at the beginning of its base period must not exceed $20,000,000; and,

(b) one or the other of the following conditions prevail:

i. taxpayer's total payroll for the last half base period exceeded by at least 30% its total payroll for the first half.
ii. taxpayer's gross receipts for the last half of its base period exceeded by at least 50% its gross receipts for hte first half.

Section 435(e) (4) defines "total payroll" and such definition excludes from payroll compensation not paid in cash. All non-cash compensation paid during the entire base period is excluded from the total payroll under this definition. The committee believes this is inequitable because it excludes such genuine compensation as notes, property or even meals served to employees. It is recommended that the phraseology "and excluding any compensation paid in any medium other than cash" be eliminated from that definition.

It is believed that, other than the exception relating to Section 23(p), the total payroll to be used in determining the test of a growth corporation should be the total payroll otherwise determined for payroll tax purposes. The payroll figures required for the submission of the W-2 form should be acceptable and corporations should not be required to re-analyze payroll for the purposes of this section.

It is recommended that the growth of a corporation should be recognized in principle under the excess profits tax law, and therefore, the limitation of the growth formula to corporations with assets of less than $20,000,000, as required by section 435 (e) (1) (A) (i), should be eliminated.

Determining Base Period Capital Addition [435(f)(2)]

49 *For the purpose of determining the base period capital addition, a corporation should be given the benefit of two full 12 month periods, even though it might be necessary to prorate the increase or decrease in an earlier period in order to accomplish that result.*

TAXPAYERS using the average earnings credit method in computing the excess profits credit are allowed an additional credit with respect to net capital additions in the base period.

Only capital additions in the last two taxable years which precede the first excess profits tax year under the law are taken into account in determining this additional credit. These two taxable years do not always coincide with the last two years in the base period. For calendar year corporations, however, they are always the years 1948 and 1949, but a corporation which has a short taxable year falling within the first or second twelve month period preceding the first taxable year under excess profits tax does not get the benefit of the base period capital addition for a full two year period.

To correct that unfairness, for the purpose of determining the base period capital addition, a corporation should be given the benefit of two full 12 month periods, even though it might be necessary to prorate the increase or decrease in an earlier period in order to accomplish that result.

Computing Borrowed Capital [435(f) and (g)]

50 *Under 435(f), borrowed capital, inadmissible assets and loans to members of a controlled group should be computed on an average daily basis and such average be compared wtih the beginning date during the base period for purposes of measuring the base period capital addition under the income credit method.*

IN DETERMINING capital additions in the base period under Section 435(f) borrowed capital, inadmissible assets and loans to members of a controlled group are taken into account only in the respective amounts at the beginning of the taxable year, irrespective of any fluctuation in such amounts during the year.

On the other hand, in Section 435(g) and in determining the invested capital credit, such items are computed on an average daily basis for the entire year.

It is recommended that for the purpose of Section 435 (f), borrowed capital, inadmissible assets and loans to members of a controlled group should be computed on an average daily basis for each taxable year, and that such average be compared with the beginning date during the base period for purposes of measuring the base period capital addition under the income credit method.

Loans to Members of Controlled Groups [435(g)]

51 *a. Loans to members of controlled groups should be treated under the invested capital credit method as now treated under the income credit method, with an appropriate adjustment for interest received.*

b. Just as increases in investments in and loans to members of a controlled group give rise to capital reductions, so decreases in investments in and loans to members of such groups should give rise to capital additions.

LOANS TO members of a controlled group are a factor in determining the capital addition under the income credit method but not under the invested capital method. Although such loans are a factor in limiting the new capital credit under Section 438, they do not operate to reduce the invested capital credit under Section 437.

It is believed that loans to members of controlled groups should be treated under the invested capital credit method as now treated under the income credit method, with an appropriate adjustment for interest received.

The components which make up the daily capital addition or the daily capital reduction are outlined under Sections 435 (g) (3) and (4). Included as additions are money and property paid in for stock or as paid-in surplus after the beginning of the taxable year, an increase in equity capital since the beginning of the first excess profits tax year and 75% of the excess of average borrowed capital for the taxable year over the daily borrowed capital for the first day of the taxpayer's first excess profits tax year.

However, daily capital reductions are created by distributions during the taxable year which are not out of earnings or profits of that year, reductions in equity capital and in borrowed capital and, in addition, according to Sections 435 (g) (4) (D) and (E), if the taxpayer is a member of a controlled group, by increases in stock holdings in, and loans to, other members of the group. In other words, there are five factors which may create a capital reduction during excess profits tax years, but only three of those factors may operate to create a capital addition.

The result is that increases in loans to a member of a controlled group during the latter part of the base period can wipe out base period capital additions arising from other sources, but the subsequent repayment of such loans during excess profits tax years does not operate to restore the capital addition.

It is recommended that just as increases in investments in and loans to members of a controlled group give rise to capital reductions, so decreases in investments in and loans to members of such groups should give rise to capital additions.

Recent Loss Adjustment [437(f)(3)(B)]

52 *Section 437(f)(3)(B) should provide (1) that the recent loss adjustment of a component which has not transferred all of its properties should be allocated between the component and the acquiring corporation and (2) for proration of the recent loss adjustment if the transaction occurs during an excess profits tax year.*

SECTION 437(f) provides for the computation of the recent loss adjustment, which is included in the determination of adjusted equity capital. Under Section 437(f) (3) (B), the recent loss adjustment shall be separately computed for each component corporation of the taxpayer, and added to the recent loss adjustment of the taxpayer. This provision, however, appears to have been erroneously drafted in its application to Part II transactions because it requires the entire recent loss adjustment of the component corporation to be transferred to the taxpayer even though only part of the properties of the component may have been acquired by the taxpayer. The result is that the component is denied the benefit of the proportionate part of the recent loss adjustment allocable to the properties it retains. However, this portion of the adjustment is used by the acquiring corporation in addition to the amount attributable to the property it has acquired. This situation is inequitable and should be corrected to provide for the transfer of the recent loss adjustment of the component to the taxpayer in the same proportion as the component's property acquired by the taxpayer is to the total property of the component.

Provision should also be made for proration of the recent loss adjustment between the component and the acquiring corporation for the year of the transaction if it occurs during an excess profits tax year.

Distributions to Shareholders [441(e)]

53 a. *The rule outlined in this section that distributions made to shareholders during the first 60 days of a taxable year which do not exceed the accumulated earnings and profits as of the beginning of the taxable year are considered to have been made on the last day of the preceding taxable year should not be applied to base period years.*

b. *Section 441(e) should not apply to any distributions to shareholders in the taxable years subject to EPT made prior to January 3, 1951 (the date of enactment).*

c. *A dividend should not be treated as a liability until the date that it is payable, or until it is paid, if no date of payment is specified, for the purposes of this section.*

UNDER THE terms of this section, so much of the distributions (taken in the order of time) to shareholders made during the first 60 days of any taxable year as do not exceed the accumulated earnings and profits as of the beginning of the taxable year are considered to have been made on the last day of the preceding taxable year. Accumulated earnings and profits as of the beginning of the year are, therefore, reduced by the entire amount of such distribution, and equity capital is likewise reduced.

However, the law specifically states that distributions made during the first 60 days of the taxpayer's first excess profits tax year are not affected by the above provision.

It would appear that the section applies to the base period years. but it is not believed that it was so intended. It is recommended that the section not be applied to base period years if such would be the application of the wording of the statute.

Section 441(e) would apply unfairly to some corporations such as those on a fiscal year ended July 31, 1950, or August 31, 1950. For example, such corporations may have paid dividends after the close of their fiscal year ending after June 30, 1950, and during the first sixty days of what would constitute their second taxable year under the new law, even though such dividends may have been paid before an excess profits tax act was proposed by Section 701(a) of the Revenue Act of 1950, which became law on September 23, 1950.

In order to prevent discrimination against such taxpayers, it is recommended that Section 441(e) should not apply to any distribution in taxable years subject to excess profits tax made prior to January 3, 1951 (the date of enactment).

It is not believed that a dividend declared before the end of a taxable year but payable on some indefinite date which may be more than sixty days after the end of the taxable year should be treated as a liability at the close of the year for invested capital purposes consistent with Section 441(e).

Sections 40.437-5(c) and 40.441-1(d) of Regulations 130 provide that a distribution is considered to be made (and the liability therefor incurred) on the date it is payable, except that where no date is set for its payment, the distribution is considered to be made (and the liability incurred) on the date when it is declared. The exception relating to an indefinite date of payment is inconsistent with the general rules for determining accumulated earnings and profits under Section 115.

It is recommended that a dividend not be treated as a liability until the date that it is payable or until it is paid if no date of payment is specified.

Reconstruct Base Period Years [442(b) and (c)]

54 *A corporation should be permitted to reconstruct up to two of the four base period years if one of such years was to be eliminated and, in any event the corporation should be permitted to reconstruct one year before making the elimination of one out of the four years.*

IF AN ABNORMALITY existed in the taxpayer's lowest year of earnings during the base period, this year will be eliminated automatically from the average base period net income computation. However, if an abnormality occurred in one of the remaining periods of 12 months or less in the base period, the taxpayer may, if it was in business at the beginning of its base period, substitute for its actual excess profits net income for the period of the abnormality an amount determined by multiplying its total assets for the last day of the period of the abnormality by the rate of return for its industry for that period.

It should be pointed out that in a case where 12 or fewer months are affected by abnormalities and such months fall within the worst year in the base period, the reconstruction of such year may result in the excess profits net income for such year being higher than some other year during the base period. Under the statute, the lowest year is required to be eliminated automatically by Section 442(b) before the reconstruction adjustment under Section 442(c) is made, so that the final result may be that the lowest year was not the one which was eliminated. To correct that situation it is recommended (1) that a corporation be permitted to reconstruct up to two of the four base period years if one of such years was to be eliminated, and (2) that in any event the corporation should be permitted to reconstruct one year before making the elimination of one out of the four years.

An illustration follows showing the effect of the proposed revision:

Assumed facts:

Base Period net income:

1946	$12,000)	Strike affecting 4 months
1947	24,000)	in 1946 and 2 months in 1947.
1948	50,000	
1949	40,000	

	1946	1947
Assumed total assets	200,000	200,000
Assumed industry rate of return	21.5%	17%

Present method of reconstruction:

1946	Actual		Dropped
1947	17% of 200,000	34,000	
	Less interest	1,000	33,000
1948	Actual		50,000
1949	Actual		40,000
Total			123,000
Average base period net income			41,000

Proposed method of reconstruction:

1946	21.5% of 200,000	43,000	
	Less interest	1,000	42,000
1947	17% of 200,000	34,000	
	Less interest	1,000	
	Reconstructed	33,000	Dropped
1948	Actual		50,000
1949	Actual		40,000
Total			132,000
Average base period net income			44,000

(The 110% test is met in both illustrations)

Relief on Combined Basis After Part II Transaction [444, 446]

55 *The Code should be amended to provide that a corporation be permitted to use the relief sections notwithstanding its acquisition of components which themselves would not be entitled to relief, providing that the corporation meets the qualifications for relief on a combined basis.*

ACCORDING to the present provisions of the Code, a corporation already entitled to relief because of an increase in capacity for production or operation according to Section 444, or because it is in a depressed industry according to Section 446, is deprived of such relief if it acquires substantially all the assets of a component corporation in a Part II transaction occurring after the base period, unless the component itself is entitled to relief under one of the relief sections, namely, Sections 442(d), 443, 444, 445 or 446. This treatment is inequitable. If a corporations is qualified for relief on a combined basis after a Part II transaction, it should not be denied relief merely because of the Part II transaction. The Code should be changed.

Calculating Industry Rates of Return [447]

56 a. *The industry rate of return provision should be amended to provide that the rate of return, calculated by the Secretary of the Treasury, should be the average for the industry's best three years out of the four year period, 1946 through 1949.*

b. *The industry rates of return should be more accurately determined because as presently computed they ignore* *the adjustments required to be made after examination of returns by Revenue Agents to reflect the excess profits credit. Some percentage adjustment is needed to allow for these over-all factors, and it is urged that the Secretary of the Treasury be directed to make a study to determine the amount of the adjustment.*

c. *The Secretary of the Treasury should be directed to make a study leading to the calculation of rates of return for each of the 3 digit subgroups listed under the major industry groups in the Standard Industrial Classification Manual.*

IN MOST OF the relief formulas, provision is made for computation of the substitute base period net income by use of the base period rate of return for the taxpayer's industry classification.

The Secretary of Treasury is required to determine and proclaim for each industry classification a base period rate of return, which is computed by aggregating the net income and interest deductions reported by the corporations in the industry during the 4-year period 1946 through 1949, and dividing the aggregate by the sum of the total assets of such corporations for such four years.

Corporations which qualify for relief and are permitted to use the base period rate of return are, therefore, required to use an average of four years, whereas corpoations which are entitled to use the income credit based upon their own experience use the best three years out of four.

Accordingly, the industry base period rate of return provisions should be amended to provide that the rates of return, as calculated by the Secretary of the Treasury, should be the average for the industry's best three years out of the four-year period 1946-1949.

In computing the base period rate of return, the statute provides for a computation based upon information shown in returns filed, which figures do not reflect subsequent adjustments to net income made by Revenue Agents as a result of their examination of returns. Experience has proved that such adjustments in the aggregate always result in net assessments of additional taxes — in recent years producing almost two billion dollars a year for all returns — and, accordingly, represent substantial increases in the net income reported in the returns. Furthermore, the net income reported in the returns does not represent the excess profits net income which would result after adjusting for the factors set forth in Section 433(b). Likewise, the total asset figure used in computing the rate of return should be adjusted to eliminate inadmissible assets and loans to members of controlled groups.

The omission of all of these factors work against the taxpayer. To correct that inequity, it is recommended that the industry rates of return be more accurately determined by allowing for the above factors by an over-all approximate, even though arbitrary, percentage factor to be added to the base period rate of return as recommended herein.

It is suggested that the Secretary of the Treasury be directed to make a study leading to the determination of the percentage adjustment to be used, and to report thereon to the Congress as soon as practicable.

The law requires the Secretary of the Treasury to determine rates of return according to the industry classifications specified in the Standard Industrial Classification Manual prepared by the Division of Statistical Standards, Bureau of the Budget, by major industry groups.

Each Major Group represents a segment of American industry. For example: Major Group 28 is Chemical and Allied Products. However, Major Group 28 is divided into nine smaller groups, such as, 281 — Industrial Inorganic Chemicals; 282 — Industrial Organic Chemicals; 283 — Drugs and Medicines; 286 — Gum and Wood Chemicals; 287 — Fertilizers; etc. In a similar way, each Major Group is broken down into numerous Groups identified by a three digit number. There are only 64 two-digit Major Group classifications used in determining the industry rates of return.

As illustrated by the breakdown for the chemical industry shown above, each Major Group classification is composed of many industries which are operated under widely divergent conditions but which, according to the law, are presumed to be enough alike to warrant using a common rate of return.

Actually, there is a material and frequently extreme difference as to rate of return among industries in the same Major Group. This situation results in inequity for the three-digit industry classification which customarily shows a higher rate of return than many of the other industry groups lumped into that particular Major Group.

To relieve that inequity, the committee recommends that the Secretary of the Treasury be directed to make a study leading to the calculation of rates of return for the three-digit industry groups for the base period years, and to report thereon to the Congress as soon as practicable. Such rates of return would be more realistic than those presently used and, therefore, fairer to the taxpayer.

Definition of "Property Paid In" [458(d)(2)]

57 The definition of "property paid in" for the computation of historical invested capital should include the value of services rendered and the amount of debts liquidated through the issuance of shares of stock or paid in as a contribution to capital.

THIS SECTION definies property (other than money) previously paid in for stock, or as paid-in surplus, or as a contribution to capital as property paid in for the purpose of computing equity invested capital used in arriving at historical invested capital. That definition should be amended to specifically provide that such "property paid in" includes the value of services rendered and the amount of debts liquidated through the issuance of shares of stock or paid in as a contribution to capital. Such a change in the definition would be consistent with the recognized accounting definition of capital and would provide a more equitable means of determining historical invested capital for excess profits tax purposes.

Allocation of EP Credit of Component Corporation [461]

58 *a. Under Section 461(c), adjustments of the excess profits credit by the component corporation should be required only if the acquiring corporation takes advantage of the exchange provisions.*

b. The organization of a new subsidiary by the transfer of cash alone to the subsidiary by a corporation in exchange for stock should not be treated as a Part II transaction or, in the alternative, should be treated as a Part II transaction only at the election of the taxpayer.

PART II GRANTS certain "acquiring corporations" the right to use the base period experience of their predecessors (component corporations) if such use produces a greater excess profits credit than otherwise. While these alternative excess profits credit computations are elective for the acquiring corporation, the allocation of the credit is mandatory for the component corporation under the provisions of Section 461(c). That is unfair and the section should be amended to provide that adjustments by the component should be required only if the acquiring corporation takes advantage of the exchange provisions.

Another inequity in this section arises because the regulations under Part II (Section 40.461-2(b)) provide in effect that if a corporation organizes a new subsidiary transferring only cash to the subsidiary in exchange for stock, there may be a Part II transaction. In that case part of the excess profits credit of the parent company must be allocated to the subsidiary. In many instances this rule operates inequitably because the income of the parent is not really reduced by the transfer of the cash, and the subsidiary may enter in a new business which may not be profitable for a long time. It would be more equitable to provide that such a cash transfer is not a Part II transaction at all, or, in the alternative, to permit an election to consider the transfer of cash as a Part II transaction.

AMERICAN INSTITUTE OF ACCOUNTANTS

Committee on Federal Taxation

FOR THE FISCAL YEAR 1952-1953

THOMAS J. GREEN, *General Chairman*....................New York

SUBCOMMITTEE ON CURRENT TAX LEGISLATION

WALLACE M. JENSEN, *Chairman*....................Michigan

ROBERT CALDWELL, JR.......Pennsylvania
HOWARD F. ELIN....................New York
BENJAMIN HARROW..................New York
EVERETT C. JOHNSON..................Illinois
JAMES J. MAHON, JR...........Pennsylvania
LESLIE MILLS..........................New York
B. S. MOTHERSHEAD........................Texas
HILARY H. OSBORN..................Tennessee
CHARLES N. WHITEHEAD........California

SUBCOMMITTEE ON LONG-RANGE TAX POLICY

J. S. SEIDMAN, *Chairman*....................New York

RUSSELL S. BOCK......................California
WALTER M. BURY......................Michigan
HAL CANARY..........................Tennessee
J. S. COWING.......................Pennsylvania
J. P. GOEDERT.............................Illinois
HARRY J. KUEHN........................Missouri
DONALD A. MILLER..........................Utah
RAYMOND R. MORRIS................Arkansas
BRADLEY O. TURNER................Kentucky
ROSS T. WARNER......................Oklahoma

SUBCOMMITTEE ON TAX ADMINISTRATION

W. HERBERT DANNE, *Chairman*....................Washington, D. C.

MICHAEL D. BACHRACH......Pennsylvania
WILLIAM J. CARTER....................Georgia
MILTON C. CHARLES................New York
WALTER R. FLACK..........................Texas
W. WALLER GROGAN................Kentucky
WILLIAM W. JOHNSTON....Massachusetts
MARY LANIGAR.........................California
JOHN F. PRESCOTT..........North Carolina
TROY G. THURSTON....................Indiana
T. DWIGHT WILLIAMS..............Oklahoma

CHARLES E. SIGETY....................*Assistant to the Committee*

The American Institute of Accountants

is the national professional organization of certified public accountants. Affiliated with the Institute through its Council are 53 societies of CPAs in the states, territories, and District of Columbia. It is a non-profit organization devoted to research, education, and professional development; membership is by election after appropriate examination of applicants. The Institute, founded in 1887, today has a membership of over 21,000 CPAs, representing most of the firms of certified public accountants and local practitioners throughout the country. Only CPAs are eligible to join. All members subscribe to a code of professional ethics.

THE INSTITUTE twice yearly prepares the uniform CPA examination which is used by state boards of accountancy in all 48 states, three territories, and the District of Columbia.

IN RECOGNITION of professional responsibility for the public welfare, appropriate Institute committees from time to time submit to the Congress, government officials, and others, recommendations from the point of view of professional accountants with respect to such matters as federal taxation, federal government accounting and budgetary procedures, organization and functioning of government agencies dealing with the revenues and financial administration.

THE INSTITUTE'S COMMITTEES on accounting and auditing procedure issue statements which are recognized as authoritative pronouncements on generally accepted accounting principles, financial reporting, auditing standards and procedures. They have contributed substantially to bringing about greater uniformity and comparability in financial statements.

THE MONTHLY MAGAZINE, *The Journal of Accountancy*, is subscribed to not only by all AIA members, but also by more than 40,000 other persons concerned with accounting. Other publications include an annual survey of corporation financial reports, a handbook for public accounting practitioners, and numerous technical, educational and public information publications.